

GROUP OF THIRTY

Risks in International Bank Lending

*First Report of the International Banking Study Group
of the Group of Thirty*

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Risks in International Bank Lending

Introduction

The purpose of this study is to discuss the greater risks that may have arisen in the course of the rapid growth in international bank lending during the 1970s and to make suggestions aimed at strengthening the capacity of the system to manage those risks.

The report is the work of a study group on international banking that was established by the Group of Thirty in mid-1980. The establishment of the study group reflected a perception by the Group of Thirty that the growing integration of national banking systems combined with the rapid expansion of bank lending across national borders raised a wide range of issues both for banks and banking supervisors — issues that had not been fully explored.

At their broadest, the Group of Thirty's concerns may be expressed as follows: has growing integration brought with it a loss of control? This question immediately raises many others: are the risks involved in international bank lending — and the funding of that lending — different in kind, or only in degree, from the risks inherent in all banking activity? Has it created new problems that are not readily manageable by banks or individual banking authorities working alone? Should banks be left wholly free to decide for themselves, for example, the degree to which they should "borrow short and lend long"? Or the extent to which they should finance countries' balance of payments deficits? How far-reaching would be the implications of a default by a major borrowing country, or a collapse of a large bank? Are existing arrangements for 'risk containment' adequate?

Such were the range of questions which the study group was asked to address. In raising the issues in this way, the Group of Thirty did not mean to

imply that it believed that international banking had suddenly become more risky. The Group recognized that the banking system had performed its "recycling" role in a remarkably smooth fashion, and without major mishap. Equally, the Group recognized that banking supervisors were themselves examining issues raised by the growth of international bank lending, and were monitoring developments in this field. At the same time, the Group believed that a study conducted by practicing bankers in cooperation with banking supervisors and others with wide experience in this field could make a distinctive contribution to public discussion and understanding of these issues.

As background for its deliberations, the study group commissioned a review of existing literature on international banking supervision and risk and some original analysis of selected topics, much of which took the form of papers specifically prepared for study group meetings. The bibliographic search and many of the analytic studies were undertaken by research staff of the U.S. Office of the Comptroller of the Currency (OCC). (Two such studies are appended to this report.) Direction and oversight of the background efforts were carried out by the Study Group's executive secretary, C.F. Muckenfuss III (at that time Senior Deputy Comptroller for Policy at the OCC) and study coordinators Steven J. Weiss and Judith A. Walter (Director and Deputy Director, respectively, of the OCC's Strategic Analysis Division). The Group of Thirty owes a debt of gratitude to them and to many others who have assisted in the work of the study group, notably to Mr. Inigo Woolf and Charles Larkum of Midland Bank and Mr. John Henderson of Schroders.

The present report, which gives the results of the study group's deliberations, should be read in conjunction with the results of a comprehensive survey of banks conducted by the Office of the Group of Thirty on behalf of the study group, published under the title "How Bankers See the World Financial Market".

The following report focusses on three areas:

- (1) country risk and the rescheduling of sovereign debt
- (2) maturity transformation and the interbank market
- (3) the handling of distressed banks

The study group believes that these areas merit special attention because they cover the range of issues that are raised (or could be raised) at an international level by the expansion of international lending and growing financial integration. Other areas, such as the risks in foreign exchange trading, while more complicated and perhaps less tractable as a result of the internationalization of banking, are nevertheless more endogenous to individual bank policy and thus more readily controllable by national supervisors.

In what follows, the discussion of each topic has been cast in a uniform format to the extent possible. Background information of a factual nature is set forth briefly in the opening paragraphs of the individual subsections. Next, concerns that have been expressed relative to a given topic are summarized. Evaluation of the concerns draws on secondary sources, the collective experience of the study group, and the above mentioned survey of 111 commercial bankers entitled "How Bankers See the World Financial Market".

Robert Pringle
Executive Director
Group of Thirty

May, 1982

Disclaimer

This report was drafted by the International Banking Study Group of the Group of Thirty. Some of those who participated in meetings of the study group hold official positions and attended as observers. They cannot for obvious reasons be held responsible for the views expressed in the report. Indeed, all the members of the study group attended its meetings in a personal capacity and policy recommendations cannot in any respect be taken to represent the views of institutions with which members are associated.

Risks in International Bank Lending

1. COUNTRY RISK

The large increase in international bank lending since 1973-74 has been accompanied by significant changes in the nature as well as the relative magnitudes of such activity from the standpoints of both borrowers and lenders. One of the distinguishing characteristics of many international loans during this period has been their purpose — the funding of current account deficits. Countries have resorted to overseas borrowing on an unprecedented scale to cushion the impact of adverse changes in their external circumstances — notably spiraling energy costs — and to finance industrialization and economic development programs. The result, for a number of borrowers, particularly some LDCs, has been a rapid increase in debt burdens, aggravated by high interest rates. For example, the ratio of debt service to export earnings for ten major LDC exporters of manufactured goods is estimated to have jumped from 13 per cent to 21 per cent between 1974 and 1981¹. The outstanding debt owed to banks by four groups of major borrowers — smaller European countries, OPEC, Eastern Europe and non-oil LDCs totalled nearly \$400 billion at the end of 1980.²

Moreover, whereas balance-of-payments financing needs were formerly viewed as short-term, cyclical, liquidity problems, current payments imbalances are often structural in nature. As a result, many borrowing countries now face periods of basic structural readjustments. Thus, greater demands are being placed on domestic management capabilities of borrowing countries to devise and implement the necessary economic adjustment programs.

While borrowers' debt burdens have grown, so have the relative magnitudes of banks' international loans in loan portfolios. Recent U.S. data

¹ IMF: *World Economic Outlook*, June 1981, p. 135.

² BIS Annual Report, 1981, p. 105.

highlight the growing importance of LDC borrowers: the aggregate exposure of the nine largest U.S. banks to LDCs has increased from 1 ½ times total capital in 1977 to more than double capital in 1980, and by the end of 1980 there were 80 instances of U.S. banks with exposure to single LDCs greater than 30 percent of capital funds. More generally, foreign assets and liabilities now account for a large proportion of total assets and liabilities of the banking systems of many OECD countries: for the OECD as a whole, the ratio nearly doubled during the 1970s, from 12 per cent to about 22 per cent.

Risks and Concerns

The extension of credit across national borders in non-local currencies complicates the traditional assessment of a borrower's ability to repay because "country risk" is a factor. Under the rubric of "country risk," most analysts distinguish "transfer risk" from "political risk".³ "Transfer risk" is the danger that a country may impose restrictions on remittances of capital, dividends or interest payments to foreign investors as part of its economic policy. In addition, repayment may be endangered by political developments, like civil or local wars.

Recently, concern about country risk has increased. There is a general belief that, at the same time as more and more banks are involved in international lending and the relative magnitude of the international portions of loan portfolios has been growing, the actual risk inherent in such activity has grown. At the same time, there is skepticism about the efficacy of approaches that banks have taken to country risk assessment.

The concerns suggest two lines of inquiry:

- 1) Have the risks of international lending increased? If so, how?
- 2) How are banks managing those risks? What is the supervisor's role?

³ A few definitions of terms may be useful to the reader:

Country risk is taken to refer to the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfill their foreign obligations for reasons beyond the usual risks which arise in relation to all lending.

Country risk assessment, following on from the above, refers to the methods used (by lending banks in particular) to evaluate the risk of an interruption in the servicing or repayment of obligations by borrowers of a particular country.

Country exposure is taken to refer to an individual bank's or banking group's exposure in its total claims on borrowers in individual foreign countries. Measures of exposure to a particular country may take account of guarantees or other factors that could shift risk to a different country from that of the borrower.

Country indebtedness is taken to refer, in an international context, to the sum total of external borrowing by a particular country from all sources.

Sovereign risk arises from the special risk associated with a sovereign loan, which is a loan to, or guaranteed by, a government (and some government-guaranteed bodies). The special significance of such lending lies in the risk that it might prove impossible to secure redress through legal action i.e. the borrower might claim immunity from process or might not abide by a judgment.

The second area, that of risk management practices, in turn raises a series of subsidiary questions:

- What techniques of risk management and/or reduction are employed?
- Is country risk assessment effective? What are its flaws?
- Are some banks better positioned than others to assess country risk?

Gauging the Overall Risks

The most frequently used indicator of the risk of bank lending activity is the loan loss record which can be used to assess risks in relation to particular categories of lending. Across-the-board data for major international banks engaged in international lending are not available, but the loan loss statistics for the largest U.S. banks may be representative. By this measure, the record appears to be reassuring since loan losses have been far lower for international than for domestic activities. Moreover, the loss record has been improving. For the ten largest U.S. banks, international net loan losses as a percent of average international loans dropped from a record 0.39 per cent in 1976 to 0.10 per cent in 1980. International net loan losses relative to total losses have also dropped, from a peak of 29.3 per cent in 1977 to 15.3 per cent in 1980. However, such statistics do not reflect the less direct costs of reschedulings to banks. Although most banks say those indirect costs in management time, liquidity, income and portfolio quality have not been high to date, many believe those costs may grow.

The views expressed in the accompanying banking survey⁴ on future riskiness of international bank lending were mixed: 40 per cent of respondents expected a 'substantial increase' in the riskiness of international lending over the next five years to the end of 1986, but a majority expected 'no significant change' or a 'modest increase'. A large number of reschedulings involving large sums or a default by a major country borrower were seen as the most serious threats to the system.

How Banks Assess Country Risk and Manage Exposures

Existing systems for assessing country risk vary in approach and complexity from bank to bank. The study group's bank survey confirmed that nearly all banks have increased the resources dedicated to country risk analysis (it also confirmed that smaller banks rely more than larger ones on country risk assessments by others, such as syndicate leaders and correspondent banks).⁵ However, there are acknowledged problems with both the economic and the political sides of country risk assessment systems.

⁴ "How Bankers See the World Financial Market", Group of Thirty, May 1982.

⁵ Appendix I summarizes nine systems which have been used or are in use at some major U.S., Canadian, and European banks.

The more serious problems on the economic side stem from the deficiencies of the data. True, the quality of data has improved somewhat in recent years, and additional efforts at improvement are currently under way. (For example the IMF and BIS have recently been discussing efforts to expand and improve banking information.) Nevertheless, there remain some significant deficiencies in both the quality and availability of the data.⁶

Lags in data reporting can be quite serious, sometimes rendering the available statistics virtually useless. There is much evidence that many banks simply did not know the magnitude of the debts of either Turkey or Poland, before the crises in those countries erupted.

Even assuming reliable and current economic data, however, there are still differences of opinion regarding how well banks use and interpret the data. There are past instances, for example, of banks' enthusiasm for lending being based on a country's natural resource endowments without a concomitant realistic appraisal of the country's ability to *manage* its natural resources. Currently, most country risk analysis systems utilize a number of economic indicators to develop measures that serve as indicators of country risk. While the ratio of debt service to exports is widely acknowledged as an important measure, opinions differ as to the significance of a number of other measures often used to predict the ability to service debt.

Recently, banks have placed increased emphasis on assessing political and social factors in borrowing countries. A number of banks have hired political experts and incorporated political considerations in their analysis in new ways, including attempts to develop lists of socio-political "early warning indicators." However, such judgments are no doubt even more problematical than economic analysis. Despite new attempts to take political factors into account, such analysis has often failed to detect important trends, such as political developments which, for example, in the case of Poland, may have contributed to the need to reschedule.

In the end, of course, even very sophisticated country risk assessments may be overridden by other considerations. Final action may run the range from voluntary decisions, based for example on perceptions of marketing opportunities, to those that are less than fully voluntary. Examples in the latter category would include situations where the bank is afraid of jeopardizing a large existing exposure if it withholds new loans or instances of strong external pressure from the bank's home government arising from foreign policy motivations: one quarter of banks responding to our survey believed that lending had been significantly affected by such pressures. Also, since a bank's competitive status depends importantly on the regard

⁶ Country debt service data, for instance, do not capture all annual amortization requirements; military debt, which is often large, is usually excluded from official statistics; and statistics on short-term debt (up to one year) are frequently deficient.

of others in the system, some banks may feel pressured by the desirability of cooperating with other lenders. Finally, some banks may act, at least in part, out of a sense of responsibility to help maintain the longer-run stability of international lending markets.

Competitive pressures may lead banks to override country risk assessments and engage in imprudent lending. Particularly in the early stages of country lending, competitive behavior tends to dominate. This can mean that new money will continue to pour into a country once it is "in vogue," even though signs of economic difficulty may already be evident. For instance, in the cases of Peru, Turkey and Poland, even when banks were beginning to feel more cautious about further lending, those countries were able to sustain the inflow of funds. In such ways, a country can accumulate excessive debt.

Debates about the efficacy and actual use of country risk assessment systems notwithstanding, banks can and do protect themselves from undue risk concentrations in a number of ways. For example, there are means by which banks reduce or spread the risks of involvement with a particular lender. These include syndication of large loans, co-financing with multilateral institutions, insuring loans with either private or public agencies, or securing home government guarantees through national export banks or agencies.

Most importantly, banks typically follow policies and practices promoting loan portfolio diversification as the main method of managing international risk exposure. Nearly all banks set lending limits to individual countries, sometimes as a proportion of capital and reserves or of external or total assets. To arrive at limits, subjective judgments (whether derived from elaborate country risk analyses or not) are translated into objective ceilings. Most banks can follow strategies that allow them to allocate, measure, and monitor quite closely their country risk exposures.

Supervisory Practices

Supervisory practices also play a part in the management of country risk. In general, the principal role of the supervisory authorities is to help the individual bank carry out the task of country risk assessment on its own responsibility and to satisfy themselves about the ways in which the bank evaluates country risk and monitors its own exposure to each country. It is not entirely clear how and to what degree various national regulatory authorities currently fulfill this role. However, bank supervisory evaluation of bank's country risk systems does appear to be becoming more widespread. Also, supervisors follow more closely than formerly trends and concentrations of risk in their banking systems, and/or at individual banks, by collecting statistical reports on country exposure. In the U.S., because of the nature

and history of bank supervision, supervisory authorities make an independent judgment regarding the risk in lending to particular countries.

The practice is not much in evidence elsewhere; but many countries apply requirements designed to prevent undue risk concentrations. (A description of supervisory systems in a number of G-10 countries is at present being prepared by Richard Dale of the Brookings Institution, to be published later this year as part of the overall work of The Group of Thirty. Meanwhile, a brief overview of relevant national regulatory arrangements is supplied in Appendix D).

Conclusions

There have been no major disasters for the international banking system arising from the growth in international lending activities. However, our survey confirms that most bankers believe that risks have increased and will increase more rapidly in the future. Evaluating the degree to which this may be true is of course no simple matter. For instance, there are factors which appear to mitigate the relative burden of debt for some borrowers. These include growing GDPs, higher levels of reserves, and above all improvements in economic policy-making in most debtor countries enhancing their own ability to adjust to changes in external circumstances. Yet the rapid growth and relatively high level of international indebtedness has certainly increased borrowers' vulnerability to exogenous events which could impair their ability to service debt. At the same time, the growth in the ratio of international to domestic assets in bank portfolios suggests that the system's vulnerability to 'shocks' may also have increased.

The concerns generated by aggregate figures on debtor condition and country exposure are often exaggerated. A variety of official support functions are already in place. To the extent that ultimate country lending risks are borne by government or multilateral institutions which lend directly, co-finance with banks, subsidize, insure or guarantee bank loans, the actual risk of commercial banks is at least partly underwritten.

More significantly, borrowers represent a range of risks, and banks manage their exposures with the intention of avoiding undue concentrations of risk. Especially in the last several years, banks and their supervisors have devoted considerable effort to improving management of international loan portfolios. The question remains as to whether these efforts are fully adequate at a time when the system has probably become more vulnerable to shocks — and perhaps more likely to experience them. Weighing these partly conflicting considerations, the study group believes the following observations are relevant:

- 1) Banks' decision-making sometimes appears to take place against a background of insufficient factual information. This is partly because

there remain serious inadequacies in the data upon which country risk assessments are based. International debt data for short-term borrowing are particularly deficient. Further efforts should be made to improve the quality, timeliness and availability of the basic economic data available to lenders.

2) To this end, means for centralizing data collection could be explored. Many members of the study group believe that some degree of centralization of data analysis would be also be appropriate. Judgments and decisions, however, should be left to individual banks.

3) Risk assessments may be influenced by other considerations. There is evidence that competition for business within the international banking market has sometimes resulted in excessive debt accumulation by borrowers, leading subsequently to debt servicing problems.

4) The study group believes that bank supervisory authorities should be concerned with reviewing country risk management systems. However, it is not yet possible to reach firm conclusions about the effectiveness of such reviews. It is also the opinion of the study group that, as a general principle, supervisors should leave the task of actually making country risk assessments to the banks (while recognizing the special circumstances of U.S. supervisors, who are required by law and practice to make loan quality judgments).

2. RESCHEDULING

The number and magnitudes of country debt rescheduling have increased considerably in the last six years. Since 1956, there have been 53 official debt reschedulings involving 20 countries. Twenty-two of these involving 13 countries have occurred since 1975. In the recent past, banks have been a party in renegotiations with seven countries — Turkey, Zaire, Peru, Nicaragua, Sudan, Jamaica, Poland. Discussions are currently under way with Rumania, Costa Rica, Senegal and Liberia. The amounts involved in these reschedulings have varied greatly: \$518 million for Peru in 1978, \$421 million for Sudan and \$1.3 billion for Zaire in 1979, \$580 million for Nicaragua and \$3 billion for Turkey in 1980. Rescheduling of Poland's debt repayments of capital due in 1981 alone involved \$2.2. billion. (Poland's aggregate debt owed to banks outside Comecon, at about \$17 billion, is a different order of magnitude from that of any other country previously

involved in rescheduling).⁷ Most of the banks' exposure to loans subject to rescheduling so far, however, have been relatively small in relation to their capital or earnings.

Concerns

The possibility of a substantially larger rescheduling, or a series of them, involving large numbers of banks, has created concern whether processes presently used will be adequate for the debt rescheduling of the 1980s. First, the rescheduling process is not codified and involves large numbers of participants — official creditors, banks and other private lenders, multilateral institutions, the borrower, and sometimes, investment bankers who are advisors to the borrowers. Second, increasingly serious consequences may arise from the conflict between creditors' responses and debtors' needs.

Again, the result of the G-30 survey are pertinent to these issues. Asked whether existing *ad hoc* arrangements would be adequate to deal with more frequent reschedulings involving larger amounts than in the past, 17 per cent said no, 54 per cent were uncertain, and 29 per cent said yes (i.e., were content with existing arrangements).

The concerns point to two sets of questions:

- 1) What are the arrangements usually adopted for rescheduling, their strengths, weaknesses, and risks?
- 2) What have the terms of rescheduling been? What have the consequences been for lenders and borrowers?

The Rescheduling Process

The rescheduling of official debt is handled by the Paris Club, an *ad hoc* group of western official creditors which, since 1956, has met informally when needed under the chairmanship of the French Treasury. Although there are no formal rules, the Paris Club has over the years adopted a set of unwritten procedures. The common practice is that the request for a meeting is initiated by the debtor country; generally the creditors have agreed to convene only after payments arrears have already occurred; and an agreement is concluded after the borrower has agreed to an IMF stabilization program. Since the only debt eligible for consideration is government obligations, the practice has been to include as participants at the meetings only the borrower and the principal OECD government

⁷ Under an agreement signed in April, 1982, repayments of the \$2.2 billion in capital that fell due in 1981 is to start in December 1985 and end in December 1988, with the interest rate for the sum rescheduled set at 1.75 per cent over LIBOR.

creditors. Observers may include other government creditors, the IMF, World Bank, the OECD and UNCTAD. The unwritten rules extend also to the amount eligible for rescheduling (about 80 per cent of consolidated official debt over a 2-3 year period) and the repayment terms.

Because of the changing composition of developing country debt, banks have increasingly become involved in the rescheduling process. Hence troubled country borrowers may have to seek relief from the Paris Club or private banks or both.

There is no standard mechanism for rescheduling debt to private creditors; each case has required than an entirely new process be stated. The numbers of bank creditors involved in recent reschedulings and their nationalities have been large and growing — 115 banks from 12 countries in the case of Nicaragua, over 200 creditors for Turkey, and 500 for Poland. A small number of lead banks, usually a dozen or fewer, have formed a steering committee that actually participates in discussions. The members of the group may be selected by the borrower or the major creditors or jointly.

Bank reschedulings have been costly and time-consuming. Arrangements have taken from 6 months to 4 years to complete. Participants in the numerous loan syndications have had to be contacted; sometimes primary collection of basic data on outstanding loans has been necessary. A number of times the negotiations have had to be coordinated with parallel Paris Club rescheduling discussions. Procedural quarrels have sometimes added to delay.

Even though banks begin to "close ranks" once a rescheduling appears imminent, there is still a tendency for individual banks or groups of banks to pull in different directions. Thus it has been difficult at times to get agreement on coherent strategy. A 1976 bankers' attempt to obviate rescheduling by extending a balance-of-payments loan to Peru, for example, was undercut when some other banks simultaneously reduced their short-term credit lines to Peru. Divisions among banks during a time of crisis tend to be along national lines. The divergence may have any number of roots, including relative levels of exposure to a particular country, political pressures from home governments, or different accounting practices and/or capital requirements.

In most reschedulings the IMF plays a critical part in devising and imposing needed economic adjustment programs. As mentioned earlier, since 1966 the Paris Club has refused to proceed with reschedulings until the borrower has agreed to an IMF adjustment program. Banks, too, have sometimes made their rescheduling contingent on the borrower's acceptance of IMF conditions. In the case of Peru, banks discovered that they

alone did not have the sanctions to impose conditions for economic adjustment.

Poland's application to rejoin the IMF aroused expectations that such a move would facilitate the rescheduling of Poland's 1982 debt repayment.

The IMF can play a useful role as a catalyst exerting pressure on both sides to move towards a settlement. Indeed, in the Nicaragua rescheduling, where the IMF was not itself involved, other multilateral institutions such as the InterAmerican Development Bank, World Bank, and Central American Bank for Economic Integration played a somewhat analogous role.

Rescheduling Terms

With few exceptions, rescheduling whether by Paris Club or private creditors has consisted of a lengthening of maturities of principal repayments at market rates of interest. Banks have been particularly insistent on maintaining commercial terms and (except in the case of Nicaragua) have thus far upheld the principle that interest payments may not be rescheduled. Although borrowers have negotiated for lower spreads and fees, they have tended to accept lenders' determinations of grace periods and final maturities. For Paris Club debt the average maturity has lengthened only from 8 to 10 years since 1975. Bankers have rescheduled on similar terms with average terms of 7 to 10 years with up to 3 years grace at rates of LIBOR plus $1\frac{1}{4}$ to 2 per cent.

Creditors have so far emerged relatively undamaged from rescheduling. Paris Club creditors have undertaken no concessional debt restructurings since 1971. In a present value comparison of official loans before and after the debt rescheduling over the period 1956-1980, Chandra Hardy estimated the loss to creditors at only about \$2 billion or 0.5 percent of the total debt outstanding and noted that "since 1975, there has been no loss to the (Paris Club) creditors."⁸ Although it is not possible to duplicate these calculations for bank debt, estimates indicate that private creditors have probably not suffered a financial loss on a present value basis either. From the borrowers' perspective, however, the terms have been quite onerous, failing to reflect their likely cash flows and essential adjustment plans. Short maturities and creditors' insistence on rescheduling only one year's debt at a time have increased the likelihood of subsequent liquidity problems and the necessity for a subsequent rescheduling.

Conclusions

Most members of the study group believe that the present *ad hoc*

⁸ Chandra Hardy: "Rescheduling Developing-Country Debts, 1956-80: Lessons and Recommendations" Overseas Development Council Working Paper, No. 1.

mechanism may be insufficient for the needs of the 1980s. They emphasize that future reschedulings are likely to be larger, more numerous and more complex, increasing the risks that the present system will prove inadequate, partly by creating intolerable delays. Most, then, see a need for banks collectively to be better organized to handle their role in rescheduling more effectively.

There also appears to be a need for re-thinking the principles on which rescheduling terms are struck. It is nearly always true, of course, that opinions about optimum terms for debt repayment will differ among negotiators. In some cases, the outcome appears thus far to have been reasonably satisfactory — the experience of Turkey and Jamaica may be cited. However, in some cases of sovereign debt reschedulings it has been argued that the terms have been based on an excessively narrow or short term view by the banks on their own best interest. On this argument, by focusing solely on the criterion of reaching an agreement on market terms, creditors may either have failed to recognize or turned a blind eye to economic and political realities confronting the borrowers. The result sometimes has been to set in place conditions likely to result in more problems later — an eventuality that is in the best interest of neither the banks nor the borrower.

There are precedents for less rigid approaches to debt restructuring in bank relationships with corporate borrowers. Given increasing recognition that the balance-of-payments problems of many borrowing countries stem from long-term structural development needs, the challenge for future reschedulings will be to reach terms that strike a better balance between the medium-term interest of banks and the timescale over which borrowers realistically are able to resume full debt service. While putting this forward as an ideal the study group is nevertheless aware of the practical difficulties of achieving an optimum arrangement. Banks in international syndicates are subject to different national taxes and national regulatory laws and supervision. "Equal" treatment for a borrower in an international rescheduling could mean unequal treatment for lenders. The essential point is that all interested parties should get together at an early stage in a country's debt-servicing difficulties. The study group feels that the IMF should usually play the leading role in gaining acceptance by all parties to the key elements in a stabilization program. However, in the group's judgment, there is also a strong case for considering the establishment of a representative body for the banking industry to help improve the flow of information available to lenders, discuss issues related to debt servicing difficulties and develop expertise in this area that would be of assistance to both borrowers and lenders (see chapter 7).

3. INTERNATIONAL INTERBANK MARKET

The international interbank market links banks to one another much as domestic money markets link banks within national markets. The market owes its existence to the need of banks to be able to bid for funds of a particular maturity to fund a loan of a similar maturity and their need to lay off unwanted deposits with other banks. Funds are thus shifted within the international banking system — and between the international market and domestic markets — as banks take deposits from and/or place deposits with one another. The market serves an important intermediary function between savers and borrowers on a global basis. By reallocating funds in the same currency among banks, it also permits participants to generate and/or manage liquidity.

Initially limited to transactions among major multinational banks, the market has grown from a few hundred banks in the mid-1970s to well about 1,000 banks from more than 50 countries by 1981.

According to BIS estimates, the size of the market grew from about \$182 billion in 1975 to \$522 billion in June, 1981. The world's largest banks play a predominant role in the international interbank market. The banks to which they lend typically relend a certain proportion as well. Most banks participate actively on both sides of the market. Reliance on interbank funding tends to be higher for smaller banks and newcomers in the international market, banks without a U.S. dollar base, and consortium banks. The market constitutes an indispensable source of funds for many banks' international activity; a recent study suggests that interbank deposits account for between two thirds and three-quarters of total external and Eurocurrency deposits.⁹

Two features deserve special mention — the practice of redepositing and the classification of banks according to perceived riskiness ("tiering"). It is not uncommon for funds from nonbank depositors to pass through a chain of interbank transactions before finding an ultimate borrower outside the banking system. Active trading on both sides of the market may accomplish one or more of the following purposes: (1) keeping the bank's name in the market; (2) enhancing the size of bank by increasing total footings; (3) establishing reciprocal relationships that will assure access to liquidity, or access at a reasonable price, in event of a squeeze (banks that only take funds are said to fare especially poorly when markets are tight); (4) gathering current market intelligence about both changing conditions of supply and demand in the market and the market's sense of the needs and

⁹ J.G. Ellis, "Eurobanks and the Interbank Market" *Bank of England Quarterly Bulletin*, September 1981.

conditions of individual participants. The bank survey shows that most banks re-deposit more than 40 per cent (nearly 60 per cent in the case of the largest banks) of interbank deposits.

The perceived risks of placing deposits with particular banks have been reflected in pricing tiers and/or credit limits. The number of tiers and differences in rate between them tend to increase in times of market uncertainty. The Herstatt collapse of 1974, though originating in overtrading in the foreign exchange market, appears to have provoked an extreme instance of pricing tiers; some banks paid as much as 2% above LIBOR. However, the pattern of interbank rates returned to normal within a few months.

In current practice, differentiation among banks in terms of credit lines may be more significant than the minimal tiering in deposit rates. As the study group's survey confirms, banks in the market typically establish daily and overall limits for the funds they will place with (loan to) other banks. These are usually not disclosed, committed lines but are internally imposed limits set by credit officers as parameters for bank traders.

Risks and Concerns

There are two levels of risk associated with the market — risk for individual banks based on their particular characteristics and market activity and risk for the system as a whole. First, since banks participate on both sides of the market, they are confronted with both credit and funding risks. Second, and more importantly, there is an underlying concern that because of the interbank linkages even sound banks might not be immune from a problem caused elsewhere in the system because of the knock-on effect. In the case of the UK fringe banking crisis of 1974, even perfectly sound banks suffered.

The above-mentioned survey by the Group of Thirty showed that a majority of banks feel that interbank activity may be becoming more risky because of a change in the composition of the market (an increasing proportion of interbank borrowing being done by second and third tier banks). And bankers rated "unavailability of interbank funds" as great a potential threat to individual banks, though not to the system, as "default by a major country debtor."

The concerns that have been articulated in the press and elsewhere can be summarized as follows:

- How have banks and bank supervisors responded to the funding risks in the market?
- Has risk in international banking increased because of growth in the interbank market? Do the inherent characteristics of the market contribute to its instability or stability?

Banking Practices

In the past, banks were "often prepared to lend on an interbank basis with relatively little financial analysis or personal knowledge of the borrowing bank . . . on the implicit assumption that a participant in the market possessed sufficient capital resources, support from stockholders (or parent bank) or a potential call on central bank assistance to be able to meet its obligations."¹⁰ In the aftermath of the international banking crisis of 1974, banks began to review this assumption, tightening and improving their credit analysis practices, utilizing stricter limits and controls, and developing more direct personal contacts.

Many banks now treat deposit placement lines in the same way as credit lines, basing overall limits and individual transaction limits on assessments of creditworthiness, including consideration of country risk (99 per cent of respondents to the G-30 survey said that country risk played a significant role in determining interbank placement and credits).

Four factors may influence decisions. First, *financial statements* may be analyzed. Some banks do a careful analysis of even the largest banks, supplemented by visits by bank staff. Banks without the resources to collect and compile financial information themselves can purchase balance sheet and income statement data along with some standard ratios from several outside sources.

There are problems, however, in interpreting annual reports because accounting conventions and disclosure practices vary widely. For this and other reasons, banks themselves as well as some of the new credit information services, place a great deal of emphasis on a second set of factors. These are the *ownership* of a bank (and the nature of its relationship to its parent institution, if there is one) and the bank's *national support systems* — the quality and degree of bank supervision and consideration of lender of last resort facilities; 69 per cent of respondents to the G-30 questionnaire said that they evaluated the willingness of the other bank's government or central bank to come to its aid in adversity. Third, banks watch for *unprofessional* money market dealings and evidence of overtrading. (This, too has its limits since skillful liability management can hide problems, although for only a short time). Finally, banks, to varying degrees, strive for a *qualitative assessment of management*.

However, not all banks exercise the same degree of care. Some banks omit or do only a cursory analysis of the very largest banks; some apply general rules of thumb, e.g., considering the largest banks in the world or in any country to be unquestionably creditworthy; and others appear to rely heavily on the judgment of their correspondents. The G-30 survey provides

¹⁰ Steven I. Davis, *The Euro-Bank* (John Wiley & Sons, 1980), p. 76.

some evidence to support the contention that some banks act on the faith that all the banks with which they place deposits are well regulated and will be backed up by their central banks, even outside the Group of Ten countries.

Although many banks assure the availability of standby lines (paying commitment fees for these when necessary), interbank lines are not always assured, and may indeed dry up for any individual bank when most needed. Many banks therefore take great care to maintain and test lines and cultivate overall relationships with other banks. Diversification of sources is clearly important. Banks employ various techniques to monitor their lines and try to gauge as well as possible how much they can tap from different sources and in different currencies and maturities. Additional business relationships may be developed to reciprocate for lines, and personal contacts may be deliberately cultivated as well.

Supervisory Practices

As with banking practices, it is difficult to make generalizations about supervision of banks with respect to their activity in the interbank market. Beyond qualitative supervision of bank practices, the capital adequacy and liquidity requirements or guidelines of bank supervisors would play a role in placing outside bounds on the aggregate level of a bank's interbank liabilities. (See Appendix D). About one third of banks responding to our survey reported that their home supervisory authority does not monitor their bank's international interbank lending and deposit placement activity.

Support Mechanisms and System Stability

The market as a whole has so far been resilient in the face of external shocks, as was demonstrated by the moderate reaction to the Iranian asset freeze. This may be partly because the breadth and depth of the international interbank market tend to limit the damage when funds are switched in response to a shock, because that causes no net loss of liquidity to the system. As a result, there is a greater chance for a reflow of funds (with adjusted rate differentials) as long as there is no generalized loss of confidence.

However, it is always important to prevent the spread of contagious mistrust. In the case of serious shock, smooth functioning of the market rests critically on a rapid restoration of confidence and may therefore, depend also on the assurance of adequate support mechanisms. The market's ultimate dependence on official support mechanisms is heightened by the nature of market relationships. Since deposit lines are discretionary, some degree of credit rationing appears likely in a general crisis. To the extent that this occurs, banks faced with a sudden unavailabil-

ity of funds and unable to obtain new funds by raising rates would be at least temporarily reliant on official support.

There are various forms official support may take — including lender of last resort and other, *ad hoc* arrangements. For the interbank market, the somewhat paradoxical role of these mechanisms in their dormant state, i.e., short of actually being called into action, is to maintain a degree of ambiguity as to when and under what circumstances an individual bank will be given support while at the same time sustaining confidence that shocks to the system will be controlled and neutralized. The ambiguity serves on the one hand to induce discipline on the part of market participants while at the same time fostering confidence sufficient to ensure that shocks will not trigger panic. Hundreds of new participants have entered the interbank market in recent years, many of them relatively small. The quality of supervision of a number of such banks from outside the major countries and uncertainty about access they might have to lender of last resort facilities in time of crisis leaves cause for concern.

Conclusions

The interbank market has functioned remarkably well; its considerable breadth, liquidity, and efficiency enable the international banking system to accomplish its enormous recycling task smoothly. The major change in the market is the proliferation in participants that has introduced second- and third-tier banks and banks from a number of non-GIO countries to the system. This bears on both the risks facing individual banks and the system risk and is the main reason why banks themselves feel that the riskiness of the market has increased.

It appears from the survey results that banking practices have changed in response, although the extent to which this is true is difficult to gauge. The treatment of bank deposit facilities as credit lines is a positive development; it is just as important for banks to perform careful credit analysis when lending to other banks as when lending to non-bank borrowers. Similarly, effective monitoring and management of funding risks are highly desirable.

For large, well known banks, taking interbank deposits may not present funding risks significantly different from other types of interest-sensitive, short-term liquid liabilities. However, smaller banks, newcomers, and banks without an established funding base are more vulnerable than the major multinational banks to increased tiering of rates or unavailability of funds in the event of a loss of confidence. The possibility of a re-emergence of steeper tiering or withdrawal of standby lines under adverse market conditions, which would naturally have a particularly marked effect on banks that are large 'net takers' of interbank funds, should add an element of self-discipline for all participants. Because of such consid-

erations, and the lack of 'transparency' of the market — the difficulty in ascertaining the ultimate sources and uses of funds — reliance on the inter-bank market bank placements as a source of effective liquidity may be less than it appears to be.

It would seem appropriate for smaller banks and new entrants to the market to exercise special care and take a relatively more cautious approach to interbank funding, but it is not clear that all of them do so. The increase in activity in Euro-market brokers may reflect a relative increase in overall deposit-taking and placing by less well established banks, and funding obtained through brokers may be less reliable in times of difficulty because it does not carry with it the backing of business and personal relationships which many banks have cultivated.

It is worth emphasising that a bank is not necessarily a better or worse risk than any other type of borrower even though it is increasingly the case that supervisory authorities in each country pay special attention to the continued stability of such institutions. Decisions to extend credit facilities to, or place deposits with, a bank must therefore be made on an assessment of the quality of management and fundamental strength of the bank concerned, the economic and political condition of the country in which it resides and a judgment of the quality of supervision in that country. The willingness and ability of its central bank to provide "lender-of last resort" support in an emergency should not be taken for granted.

4. MATURITY TRANSFORMATION

While the practice of maturity transformation, namely receiving deposits at one maturity and lending at another, is an integral part of financial intermediation, perceived changes in Euromarket conditions and practices have prompted renewed attention to the subject. On the asset side, a borrowers' market has at times produced a lengthening of maturities. On the liability side, typical OPEC preferences for short-term deposits have been reinforced by rising short-term interest rates which have induced other depositors as well to seek shorter terms.

Competition in loan markets has at times resulted not only in a lengthening of lending maturities, but also a shrinkage of loan margins, putting pressure for extra income on other bank activities. At about the same time, a shift in the U.S. approach to monetary policy, emphasizing management of monetary aggregates vs. short-term interest rates, was accompanied by great volatility of U.S. rates and hence Euromarket rates,

making portfolio management more difficult. In 1980 and early 1981, substantial losses on mismatched positions were reported by a number of major multinational banks. Others, however, profited from the new volatility of interest rates. This greater volatility increases both the risks and possible rewards of mismatching.

It is important to try to distinguish the two components of risk in maturity mismatching — interest rate risk and funding (liquidity) risk — and to understand how Euromarket practices affect each. The interest rate risk component is to a great extent alleviated (but not eliminated) by floating rates and the rollover technique which pass interest rate risk on to the borrower. The effect in a period of rising interest rates is to increase credit risk. The extent to which a bank covers itself against interest rate risk depends for the most part on how closely it matches liability maturities to the rollover maturities in its assets. If a loan that is repriced every six months is funded with 30-day money, the bank's exposure to potentially adverse changes in market rates of interest is not fully covered. In addition, smaller, less well-known banks would continue to be vulnerable to increased tiering of rates even if liabilities were completely matched to asset rollover dates.

The rollover mechanism does not, however, neutralize funding risk — that is, the possibility that a bank may be unable to tap resources to meet its continuing obligations. For the market as a whole, supply and demand are kept in balance by interest rates; however, the market response for particular banks in different circumstances can vary considerably. Banks with established names can reasonably expect to tap even a large amount of funds, when needed, and at relatively advantageous rates. For smaller, less well known banks, particularly relative newcomers or ones without a connection to the U.S. dollar market, the funding risk may be a real one.

Bank Practices

In the 1970's many banks began to re-examine procedures for asset and liability management with an eye to greater global coordination. Most banks monitor their liquidity positions with some care. As in the case of foreign exchange positions, top management sets general policy for maturity mismatches and puts limits on discretionary decisions by lower managers, based on assumptions about movements in rates. The range of practical approaches to fund management runs from centralized global control to decentralized, local (profit center) control. Neither way is clearly superior; there are advantages and disadvantages to both. Banks' actual practices vary. About 40 per cent of banks participating in the G-30 survey indicated that they had reduced limits in reaction to greater risks posed by the current volatility of interest rates.

Supervisory Practices

Bank supervisors are aware of special problems in liquidity management that may arise from banks' international operations. But direct comparison of the approaches adopted by different supervisors is rendered very difficult by the variety of techniques used to measure "transformation" and wide institutional differences. It may be noted, that about one third of banks participating in the survey said that supervisors' performance in monitoring their mismatched positions was "poor" or "fair".

Because of the inadequacy of existing statistics, the Committee on Banking Supervision and Regulatory Practices under the chairmanship of Mr. Peter Cooke has been working to try to encourage and develop a uniform reporting system to be used by the BIS to collect data on banks' maturity mismatching, particularly with regard to their international business.

A number of supervisors (e.g., France, Japan) have increasingly urged their banks to fund a proportion of their long-term foreign currency assets with long-term foreign currency liabilities, partly at least because in foreign currency business, banks have no automatic lender of last resort to turn to who is itself the issuer of the currency in question.

Conclusions

Available maturity structure data make it impossible to reach any conclusions about whether the degree of mismatch has worsened. Efforts by bank supervisors to improve the collection of statistics of this kind are thus a positive development and for these statistics to be fully meaningful it is important that the coverage of data should embrace international banks' worldwide business.

Yet even if no worsening of trends on a consolidated basis has taken place most bankers and study group members believe that interest-rate volatility has tended to increase riskiness of traditional mismatch practices. This increased risk requires banks to be more cautious. Furthermore, of course, losses themselves will tend to have the healthy effect of inducing greater discipline in bank practices. Whilst banks' managements are responsible for their own mismatching practices, supervisors must also be concerned to ensure that these are prudently established and operated.

5. DISTRESSED BANKS

The growth of the international banking system has increased the potential range of problems created by bank failure. The problems of a

single bank, unless contained, could have an impact through the international interbank market; banks and banking systems are always vulnerable to confidence crises. Moreover, the transnational structure of the international banking system and the potential global spread of contagion have enormously complicated the management and resolution of bank failures and distressed bank situations.

Three different cases of bank failures in the last decade illustrate some of the international ramifications such occurrences may have, not only the unfolding distress of the bank itself, but also the nature, extent, and timing of crisis resolution by national banking authorities.

- In June 1974, the Bankhaus I.D. Herstatt, which had incurred large foreign exchange losses, was abruptly closed by the German Federal Supervisory Authority for Credit Matters. The collapse of the bank shocked the markets, which had not previously demanded risk premia for interbank transactions. After the Herstatt crisis, rate tying appeared, and many sound banks had difficulty getting access to funds simply on the ground of being small.

In addition, by closing Herstatt at the end of the banking day in Cologne but just after the beginning of the banking day in New York where scores of Herstatt's foreign exchange contracts were in the midst of settlement, the German authorities inadvertently interrupted the international payments mechanism. Herstatt's principal New York clearing bank, Chase Manhattan, froze the account. Debit orders were not honored; credits coming in were not returned. A race for Herstatt's New York assets by its creditors from around the world ensued.

- At about the same time as Herstatt's problems were becoming more visible in the spring of 1974, U.S. banking authorities were in the midst of a protracted attempt to prevent the collapse of Franklin National Bank, then the 20th largest bank in the United States. A decision by the Federal Reserve Bank of New York to provide emergency liquidity assistance in substantial amounts had as one of its two main objectives prevention of "the severe deterioration of confidence, at home and abroad, that would have resulted from an early failure of the bank." (Federal Reserve Bank of New York, Annual Report, 1974.)

The same concern for international market stability, which was shared by other central banks as well, also prompted the Federal Reserve to acquire Franklin's foreign exchange book when the market, fearing the bank would fail to perform on contracts, began to refuse to sell foreign exchange to Franklin.

Because Franklin had a large London branch, management of the problem required the Bank of England's cooperation at two junctures. First, during the months of liquidity assistance, the steadily increasing need for collateral for Franklin's borrowings from the Federal Reserve required the use of assets at the London branch. Second, the ultimate solution, a purchase and assumption transaction, required that the Bank of England help to secure the necessary approvals under English law for transfer of Franklin's London assets to the FDIC which acted as receiver prior to the sale to European-American Bank.

- In the spring of 1980, Argentina's Central Bank ordered the liquidation of Banco Intercambio Regional (BIR), the country's second largest private bank. The exposure of foreign banks was about \$80 million. Foreign

currency deposits were not covered by Argentina's deposit insurance plan. Moreover, Argentinian authorities, claiming lack of authority, refused to accept responsibility for claims on BIR's New York branch. The New York State Banking Department took possession of the branch, hoping to be able to pay off depositors and creditors by selling branch assets.

The liquidation of BIR triggered a run on deposits at other Argentinian banks. The Argentine Central Bank was forced to inject an estimated \$2 billion to avoid a collapse of the private banking system. In the meantime, the country's \$10 billion accumulation of foreign exchange reserves had begun to drain away, leading some concerned observers to worry about the adequacy of Argentina's resources to meet a potentially prolonged banking crisis.

Concerns

Concerns about distressed banks and their impact on the stability of international financial markets spring from perceptions of the large degree of interdependence among banks from all over the world and market doubts about the ability of existing lender-of-last-resort facilities to manage and contain future crises of potentially global proportions.

A majority of bankers participating in the G-30 survey expressed their agreement with the proposition that "the international banking system would be vulnerable to a chain collapse in the event of a crisis affecting a significant bank or group of banks", although supplementary comments suggested that they considered this eventuality to be improbable. More than two-thirds said, however, that there was "a need for clearer understanding of lender of last resort facilities."

Two distinct lines of questions are raised by such firm comments:

- Do individual national authorities have the capacity (powers, resources, judgment) and willingness to act to avert an international crisis?
- Given the complex transnational structure of the international banking system, is there sufficient clarity of responsibility, i.e., which central bank is responsible for which banking institution?

Crisis Management Mechanisms

The organization of nations' crisis management systems reflects different national legislation and policies. In the United States and a few other countries, rescue responsibilities are divided among the institutions that respond to illiquidity and those that deal with insolvency. The distinction, of course, is not easy to draw, and interaction of the two functions is sometimes required to meet emerging problems. In some countries, the central bank has responsibility for handling crises both of illiquidity and of insolvency, though this is by no means true of all. However, in some of the latter countries there are other institutions for dealing with insolvency.

Crisis management mechanisms may take a number of forms, includ-

ing lender of last resort facilities, deposit insurance and *ad hoc* arrangements. Regardless of the original source or nature of an individual bank's problems, what triggers a crisis of confidence for the whole banking system is a liquidity crisis. In order to stave off or contain such a crisis, authorities must be able to provide needed liquidity quickly to avoid a panic run on deposits. Hence debates about dealing with distressed banks in an international context have tended to concentrate on lender of last resort facilities.

In the classic view, a lender of last resort is an institution which has the responsibility to provide the residual liquidity needs of the financial system rather than to specific institutions. These may arise in day-to-day activity or in emergency situations. In the latter case, the lender of last resort may prevent and neutralize the impact of financial shocks by lending to institutions during periods of crisis and by acknowledging its duty to lend in the future. In fact, the presence of a lender of last resort alone may be sufficient to sustain public confidence.

At the same time, the efficacy of lender of last resort and other kinds of support arrangements requires that they should not be viewed as providing an unconditional guarantee. Such a guarantee would have the perverse effect of encouraging some banks to take undue risks in the belief that if they got into trouble rescue by national authorities was assured.

The development of lender of last resort facilities and other types of crisis management mechanisms is closely related to the degree of maturity of a country's banking system. Such facilities are usually not questioned for the G-10 and other industrialized countries. However, as already noted, the increasing participation in the international system of banks from developing countries has given rise to some unease, in large part because the quality and commitment of their national support arrangements are not clear.

The transnational structure of the international banking system poses additional questions of access to lender of last resort facilities for several types of banking institutions. These include foreign subsidiaries and participations and sometimes even foreign branches which, in a crisis, may be unable to obtain access to their parents' lender of last resort. Increasing numbers of multinational consortium banks add their own element of uncertainty.

The Response of Banks After Herstatt

Since 1974, the behavior of banks in the interbank market has reflected varying perceptions of the support that may be made available to a distressed bank. Some banks treat possible unwillingness or inability of a central bank to support its national banks as part of country risk and may extend or withdraw credit lines as their analysis of circumstances dictates

(See answer to Question 50 in bank survey). Such analysis may include attempts to determine whether rescue efforts might be forthcoming only for large and/or government-owned banks. Once a bank is actually known or believed to be in distress, continued extension of credit from other banks rests on the belief that the authorities will provide support. Some banks will then continue to lend in an effort to maintain confidence in the system and avoid crisis while others withdraw deposits or lines; some banks that continue to extend credit may be additionally motivated by the opportunity to take advantage of relatively high rates and the hope of benefiting, over time, from having proved themselves "friends in need".

The Response of Major Central Banks

With the events of 1973 and 1974 as a catalyst, recognition of the potential need for concerted action in the event of international problems was considered at a meeting of the world's major central banks in Basle in 1974. The statement they issued reflected the classical model, that is, public concerns should be put to rest with assurance that support is available but, in order to keep the markets disciplined, the exact circumstances under which support would be forthcoming should not be formally specified. Specifically, the Governors of the G-10 and Swiss central banks announced that, after considering the problem of lender of last resort in the Euromarkets, "they recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity." But they were "satisfied that means are available for that purpose and will be used if and when necessary."

Conclusions

The study group believes that some degree of ambiguity is a necessary feature of a lender of last resort facility. Any move to spell out specific terms and conditions under which assistance would be made available to banks in distress would have the detrimental effect of undermining market discipline. At the same time, the strong views of commercial banks that there is a need for clearer understanding of lender-of-last-resort facilities were noted.

6. COMPETITION, PROFITABILITY AND CAPITAL

In explaining the narrow spreads on international loans bankers give greatest weight to supply and demand conditions and to aggressive pricing by lenders seeking to enter new markets or expand market share. The entry

of new banks into the Euromarket and expansion of international activities by previously established institutions have obviously maintained intensely competitive conditions. For example, data on syndicated loans collected by the World Bank suggest that there may be as many as 10 times the number of lending institutions in the syndicated loan market today as there were in 1972. Of those that the World Bank identified by name (institutions in the first nine or ten manager positions), one-third of 1980's syndicated loan managers are headquartered outside Europe or North America, compared to only one-eighth in 1973: See Appendix C.

Concerns

Perceptions of increasing risk in international lending are frequently accompanied by concern that, with spreads on loans squeezed by intense competition, returns are not commensurate with risk. Moreover, there is concern that the narrow margins lead to lower profits, thus impairing banks' ability to maintain adequate capital ratios.

The remainder of this section will explore the following questions:

- What is the relationship between quoted spreads and bank profitability?
- How have banks responded to narrower margins?
- Does competitive pressure come particularly from some banks with competitive advantages?
- What has the supervisory response been?

The Effect of Spreads on Profitability

Quoted spreads are a guide to establishing borrower costs, not measuring profit margins, if only because banks' average costs of funds are usually below LIBOR, front-end fees on loan agreements provide further compensation and there is the unquantifiable benefit of other business kept or gained.

In general, large banks enjoy wider gross lending margins because of their lower average cost of bought-in funds. They and banks that take lead roles are more likely to gain more also from fees and related business. Participants that do not have such advantages — or have them to a lesser extent — have some offsetting benefit, however, since they do not incur as much indirect (non-funding) costs as the lead banks.

The question of what level of spreads is "acceptable," i.e., likely to generate an adequate net return, is a very difficult question for any individual bank. Analysis of the profitability of international lending, and international operations generally, poses problems which include allocating indirect costs. It has been reported that many bankers have been dissatisfied with their own internal data and profit-center analyses. The difficulty of accounting for the true economic cost of rescheduled loans, discussed earlier, further complicates the issues.

Follow-up interviews to a previous Group of Thirty survey yielded some "guesstimates" on profitability from non-U.S. banks. Most estimated their true gross return at about 0.25 per cent above quoted spreads. Also, most estimated their breakeven point at about $\frac{3}{8}$ per cent over LIBOR plus some elements of front-end fees.¹¹

The record shows that individual lenders are not able to stop the erosion of loan spreads. Since banks feel in many cases compelled to maintain market presence, the principal results of a bank's attempt to hold the line at a given "acceptable" spread may be a deterioration in the quality of its loan portfolio.

Sources of Pressure on Margins

Some banks have competitive advantages that arise from the regulatory regime within which they operate. Highly leveraged banks can lend at relatively low margins and still earn a reasonable return on equity. Also, because there is less emphasis on profitability, some government-owned banks or savings banks may have a similar pricing advantage. Finally differences in reserve requirements and other regulatory measures can also have an impact on competitive abilities of banks, especially if they were to be manipulated to promote or discourage international activities.

However, not all competitive pressure comes from banks with regulatory advantages. For example, sluggish domestic loan demand may lead to more aggressive pricing by banks from different countries at different times. Also, more recent entrants may at any given time be competing more aggressively to gain market share or carve out a special niche. Finally, even the more established institutions may adopt a competitive strategy of cutting price to increase market share. Waves of intense competition from various groups of banks tend to maintain the pressure on margins.

Such competitive pressures in the market are expected to continue. The bank survey identified varying capital requirements as the main factor distorting competition, in the view of bankers. Differences in regulation were thought by a majority to be "somewhat" important factors affecting competition.

Supervisory Capital Requirements

The continuing decline in spreads, since 1976, in spite of some recent recovery, and perceptions of increased risks in the market, has prompted special attention to capital adequacy on the part of banking supervisors from the major industrialized countries. Germany and Switzerland, for

¹¹ "The Outlook for International Bank Lending", G-30, August 1981. It should be noted that these guesstimates were highly qualified since many respondents indicated they are not able to monitor efficiently their marginal cost of dollars, and most admitted that inability to allocate overheads, etc., made costing unreliable.

example, have recently widened the scope of their capital requirements in order to encourage their banks to increase provision for the risks they incur in their international activities. A brief outline of capital adequacy requirements is given in Appendix D.

To the extent that capital requirements are effective, they should ultimately constrain expansion of lending when returns are inadequate. Reportedly, some Swiss and German banks have reduced their international lending activity in reaction to new or proposed requirements, and some banks in London claim to have been constrained by Bank of England capital adequacy guidelines, although it is not clear whether this has had any direct impact on their international business. A previous Group of Thirty survey revealed that respondents' banks believe capital adequacy will be one of the more important constraints on future international lending, although not necessarily a very significant one.

The BIS, in its April 1980 communique, listed capital adequacy as one of the three elements of international banking soundness to which the central bank governors attach "cardinal importance", and endorsed the efforts of the Cooke Committee in this area. It seems likely pressure by national authorities to sustain adequate levels of capital will continue, and will be beneficial for the protection of the earning capacity of the international banking system as a whole. This may be accompanied by some move towards convergence of different countries' capital adequacy standards, although this is likely to be a fairly long-term prospect.

Conclusions

It is the opinion of the study group that supervisors should not attempt any direct action to increase loan margins. There may in any event be practical limits to the efforts of individual supervisors, because of possible disadvantages to their banks from prudential requirements that are significantly more stringent than their competitors'. For that reason, cooperative efforts among supervisory authorities are a very positive development. The bank survey revealed support for the view that requirements should be harmonized — with a preference (perhaps not surprisingly) for achieving this by reducing rather than raising regulatory requirements.

7. FURTHER SUGGESTIONS FOR REDUCING RISKS IN BANKING

The purpose of this concluding section is to explore two suggestions for reducing risk — through a requirement for banks to make provision for

rescheduled loans and, secondly, by way of improving the arrangements for dealing with rescheduling and the flow of information on international indebtedness. These are in addition to the recommendations made in the preceding sections of this report.

Provision For Rescheduled Loans

A recently topical subject has been the question of whether banks should be obliged to make provisions against loans that are to be rescheduled. The question is whether regulators ought to move towards requiring the making of some provision against a portion of rescheduled loans at the time of rescheduling. To put it another way, rescheduling — *de facto* — indicates the existence of a loan quality problem. Even if this problem is presumably resolved through an agreed rescheduling, there is no reason to doubt that the lending institutions' judgment at time of loan origination had not been borne out. Consequently, provision against possible loss or a provision for opportunity-loss seems prudent and reasonable. It is the opinion of the study group that, as reschedulings may become more common, it would be in the interest of banks to make some provision against rescheduled debts either specifically or through the existence of some general provision of adequate size and, unless circumstances are exceptional, supervisors should encourage action on these lines.

Those who argue against this point of view note the following:

1. There is little international uniformity in the treatment of non-performing and rescheduled loans. Obviously, the inequity posed by differing rules and differing standards can be used as an argument to frustrate the basic concept of provisions for rescheduled sovereign loans. However, individual regulators could proceed along lines they deem to be best for the safety and soundness of their banking system even if other regulators are more lenient.
2. A second argument is that the requirement for rescheduling can be solved by bank refinancing. Rescheduling might be avoided by increasing loans to cover interest and/or principal payments. This technique is obviously nothing more than putting off the day of reckoning; it amounts to the same thing as a rescheduling and lacks conviction.
3. A third argument in opposition to provisioning has been that it weakens creditors' negotiating position and might tempt debtor nations not to fulfill their obligations, although there is little evidence to suggest that this has been a feature in rescheduling activities to date.

On the positive side, the argument for provisioning is that:

1. The rescheduling is, in and of itself, an indication of loan-quality problems. Such quality problems should be recognized and some portion of the rescheduled loan should be reserved both as an indication of the reality of the loan quality problem and also because of the costs involved in rescheduling, not the least of which is the opportunity cost.
2. Provisioning reinstills into sovereign lending one element of discipline

which may have diminished substantially over the past decade as losses in international lending have been contained due to rescheduling activities.

Clearly, the problems concerning provisions for losses and rescheduling activities are substantial. On the other hand, a more rigorous approach could help improve discipline within the international banking system. In addition, it would discipline the sovereign borrowers and strengthen forces making for better balance of payment adjustments. In sum, the study group believes that it is appropriate for all supervisory and regulatory authorities to encourage banks to take action in this area, although it is recognized that it is unlikely that this will be possible at least initially in any uniform way.

Inadequacies of Existing Arrangements

The study group feels that the existing arrangements among banks to deal with country debt reschedulings are unsatisfactory, being almost entirely of an ad hoc nature. In particular, the period leading up to renegotiation has been extended, to the detriment of all parties, by the need for lending banks to be persuaded to join together, pool information and appoint negotiators (recent experience has shown that it can take a long time before the major banks even know what other banks are involved). Also, the study group notes that the assembly process in respect of gathering information on cross-border claims of commercial banks is incomplete and needs to be improved.

A good example was that of Turkey where the first estimates of lending proved to be far lower than the total which emerged when banks and other creditors revealed their individual lending figures. The same happened in the case of Poland. The study group feels that it would be in the best interests of both debtor countries and creditor banks if it were possible to have a central unit in which statistics on international lending were kept complete, up-to-date and confidential. This might be undertaken by the BIS, building on their existing work, or conceivably by a new organization established by the banks themselves.

Clearly, the combination of a prolonged recession, falling commodity prices and historically high levels of real interest rates in most major countries and especially in the United States could lead to further strains appearing in the banking system, especially if a number of reschedulings were to take place either simultaneously or within a short space of time. It might well be that the banks would react to an increase in perceived risk by cutting back international lending. If the same phenomenon applied to the inter-bank market, an individual bank could find it difficult to renew deposits in the inter-bank market, thus setting off a contraction in liquidity. While these risks exist whether arrangements for rescheduling of country debts

are efficient or inefficient, the study group feels that the level of risk is unnecessarily increased because there is no generally accepted and readily activated mechanism for dealing with a potential escalation of such problems. By contrast, it was noted that in the case of official government creditors, once a country finds itself in difficulty, the Paris Club can be convened and the government creditors are able to react quickly and in unison to a common problem.

The same point applies to relationships between commercial banks and the International Monetary Fund and the World Bank. No formal (or even informal) system exists whereby representatives of commercial banks as a group and officers of the International Monetary Fund can meet regularly to discuss mutual problems. Naturally, the study group recognizes that the IMF and the World Bank would find it difficult, if not impossible, to initiate discussions with commercial banks on country problems for fear of being accused by member countries of favoring such creditors. However, it is felt strongly that this legitimate concern does not obviate the need to establish means of better communication. The overriding consideration is to establish a method or forum whereby the major actors in international lending, namely the commercial banks, the multilateral official institutions, and government creditors could find a way of working more closely with each other and with borrowers both to improve the flow of information and to react quickly in case of need.

A Consultative Group for International Banking?

The study group felt that the more rapid the action of the main actors in dealing with a debt rescheduling need, the more likely would it be that a country could resolve its problems in a timely manner without being subject to a precipitous withdrawal of credit and hence possibly unnecessarily severe domestic economic adjustments. Among various ways in which such prompt action could be encouraged the study group gave close consideration to initiatives that might be taken by the private sector of the international financial community.

One area in which further improvement is required, as noted previously in this report, is in the collection and timely dissemination of statistics on the liabilities of countries to the banking system and capital markets.

Data on international bank lending is already gathered by the World Bank and the Bank for International Settlements, but a banking bureau which could supplement information from such sources by obtaining additional information from borrowers or lenders could play a useful role in increasing the 'transparency' of the market (for example, by gathering information on the exposure of banks from different countries to particular sovereign borrowers, lending by banks outside the Group of Ten and

Switzerland, the positions of official and other non-bank creditors, and movements in short-term credit flows).

Beyond such initiatives to improve information could come the establishment of some forum (an "International Banking Consultative Group"?) in which leading international bankers would be able to discuss issues of mutual concern. It might also be able to liaise on behalf of bankers with official international and government agencies, providing these bodies with an additional forum for discussing problems concerning international capital flows and market regulation. Equally important, it would be available as an additional channel through which borrowers would be able to convey their views more effectively to the international banking community at large.

This role as a "channel of communication" might over time be found particularly useful in connection with international debt servicing problems. The body could not itself represent banks in rescheduling negotiations, but could in certain circumstances occupy a liaison role between bankers and borrowers, and between different banking interests in a problem loan situation. The possibility of conflicts of interest must be acknowledged, given that the group would be composed of bankers who are themselves active in the international field, but the group would be in a good position to look beyond such interests and focus on factors of longer-run importance.

Past experience has shown that debtors as well as creditors have much to gain from improvements in the machinery for dealing with debt problems. It would be for the "consultative group" to demonstrate through its actions that its role is a constructive one, and not narrowly sectoral in outlook. It could provide the means for bringing involved banks together quickly once a rescheduling request had been received, and in due course could be expected to develop expertise that would be of great assistance to negotiators of both parties. A "consultative group" could not, of course, have legal powers to enforce decisions, but would derive its authority from the standing of its members, the expertise of its secretariat, and from the moral support given to its work by the international banking industry. It would certainly be important to discuss the objectives of the new body as widely as possible, to demonstrate the positive role it is intended to play, and to take full account of the views of sovereign borrowers.

New patterns of international financial flows will be called for in carrying through the volume of international lending needed in the 1980's. These may include expanded use of co-financing, parallel lending and similar techniques. Progress in these directions, which has so far been disappointing, might well be facilitated if there was in existence an authoritative body amongst commercial bankers with which the international agencies could co-ordinate their thinking and establish acceptable ground rules for co-operation and joint development.

The study group fully recognized that there are likely to be many difficulties in setting up such a group. For example, the question of whether members should be formally representative of their respective national banking communities or selected in another manner would require careful consideration. On the one hand, in view of the fact the Euro-currency markets have developed on a transnational basis and that sectionalization of interest along national lines could be counter-productive, it may well be best to avoid members being nominated by national banking communities. (There is also the possibility of anti-trust conflict to be considered, though this should not be exaggerated). On the other hand, national representation would provide a more formal element of structure to the Council and perhaps strengthen its moral authority.

More generally, these areas of difficulty might be found less of a problem if in the first instance an experimental body were to be established on an informal basis. It would then grow when experience was gained, thus helping to avoid the problem of unrealistic expectations, and by this means enjoy greater freedom to set a style for future operations. Private discussions indicate that a wide measure of support exists, both inside the banking industry and among interested outside parties, for the concept of a representative international body of the kind discussed in this paper.

APPENDIX A

Commercial Banks' Attitude to Country Risk Assessment

It is possible that the 1980s will see an increase in the number of countries experiencing difficulties in the servicing of their international debts. A system which aids the early identification of such countries must, therefore, be an essential tool in the effective management of a commercial bank's lending portfolio. Concomitantly, such a system can make an invaluable contribution to the formulation of a commercial bank's marketing plans by identifying areas with potential for profitable and creditworthy lending opportunities.

This appendix attempts to summarize the "state of the art" of country risk assessment within the commercial banks with the aim of stimulating discussion on the appropriateness of the banks' approach to selected risk factors and their evaluation. The approach adopted in this analysis has been to review a number of systems which have been employed or proposed for the evaluation of country risk and which have been outlined in various recent published articles and other material. The majority of these articles relate to specific systems which are actually in use in a major international bank. (For definitions of terms, see page 6, footnote 3).

Diversity of Risk Assessment Methodology

In 1977 the Federal Reserve's Committee on Foreign Lending examined the international lending practices of 46 member banks. The study revealed that all those banks had internal systems for monitoring and controlling foreign lending but there was substantial diversity in the level of sophistication of the techniques used.

Similar research undertaken by Eximbank in the same year confirmed the variations in the methodology adopted by banks in the evaluation of sovereign risk. The Federal Authorities introduced in 1978 a paper entitled "A New Supervisory Approach to Foreign Lending" which clearly indicated that they expected each system to exhibit general characteristics, including risk assessment based on reliable and up to date information.

In practice it is difficult to envisage how such uniformity can be achieved, particularly bearing in mind the diversity of existing systems and perhaps, more importantly, the complexity and attendant problems appertaining to country risk assessment. The main problems identified are outlined under the appropriate headings in the ensuing sections.

Key Factors and Common Elements of the Systems Reviewed

For the purpose of this review of country risk assessment, eleven systems have been analyzed. A list is outlined at the end of this appendix.

The eleven systems reviewed have certain broad common factors and, in our analysis, we have grouped these into economic and political/social factors. This grouping broadly mirrors the distinction embodied in the systems themselves, which differentiates between a country's ability to service its debts (as measured by economic factors) and the extent to which the ability to repay debts is affected by political considerations (political factors).

A schedule indicating the economic and political factors taken into account in the systems reviewed is shown on pages 45 and 46.

Economic Indicators

The economic indicators which emerged from the analysis as being fundamental to country risk assessment were:

- the debt service ratio, i.e., $\frac{\text{debt service costs}}{\text{export earnings}}$
- the balance of payments position
- the exports growth trend
- the level of internal economic growth expressed in terms of one of the major economic aggregates such as gross national product (GNP) or gross domestic product (GDP).

It is evident that export performance, and hence a country's ability and capacity to generate foreign exchange, is a crucial factor. Current and expected performance in this area must, therefore, be one of the essential indicators in developing a meaningful system of country risk assessment.

An important question therefore must be: how accurate and up to date is the available data on exports and the other factors with which it is compared for analysis purposes?

Exports

One of the main sources of information on exports themselves is the International Monetary Fund's monthly publication "International Financial Statistics" which provides a reasonably accurate current account position and balance of payments trend. In addition, because these statistics provide a break-down by major product, the dependence of a country's economy on selected exports is available.

External Debt

The availability and accuracy of information in respect of a country's external debt, and particularly its constituents, is a problematical area which in turn influences the reliability of the debt service ratio. If such information is not sufficiently comprehensive or accurate, then the reliability of this risk assessment tool is in doubt. This is clearly a matter of importance, since most of the systems reviewed in this paper make extensive use of this ratio in their evaluations.

Improved data, in isolation, would not, however, resolve the problems associated with projecting this measure into the future. These problems arise because predictions of the debt service ratio should include assumptions concerning future interest rates and the levels of future borrowings.

The latter is calculable by reference to projected future balance-of-payments deficits and the extent to which these will be financed by increased borrowing. However, it is open to question whether this approach is satisfactory because assumptions concerning increased borrowing automatically imply that a country is creditworthy — the very fact which the analysis (including projected debt service ratios) is seeking to determine.

It must also be borne in mind that, to satisfy their borrowing requirements, certain countries could be recipients of loans at favorable interest rates and/or terms ('soft loans') akin to aid which would distort projected debt service ratios.

Similarly, the problem of the accurate prediction of interest rates cannot be easily resolved. The volatility of US interest rates over the last two years is clear evidence of this. Therefore, a relevant question is how the quality of the data necessary to formulate accurate projections can be improved.

Major Economic Aggregates

The data on which measures of growth in GNP and GDP are calculated emanate primarily from World Bank sources and, like the debt figures, suffer from production delays.

Despite the fact that a country with a rapid growth rate would appear to be a sounder economic prospect than one with a contracting economy, experience tends to show that there is little apparent connection between risk and either GNP/GDP totals or growth rates in these aggregates.

The question must, therefore, be asked: why are such indicators, which correlate poorly with historic rescheduling experience, often included in risk assessment systems? Is it because they are generally accepted as the most important indicators which modify the overall view of a country as presented by the export related indicators? If so perhaps these indicators should be seen as a checklist of the thoroughness of the assessments made in arriving at a country's likely export performance.

Other examples of such modifying indicators include:

- the inflation rate,
- the growth in a country's capital stock as measured by the level of gross capital formation,
- the economic diversity within a country,
- money supply growth rates.

Overall one could speculate whether, in fact, these qualitative indicators do contribute to the operational success of an economic analysis system. If it can be shown that they do not contribute, could the argument be advanced that the examination of factors, other than those relating to exports and indebtedness, is unnecessary?

Political Indicators

The need to define terms clearly is even more imperative when considering political factors. However, it is possible to identify two main groups of factors which are felt to be fundamental to the assessment of political risk.

These are:

- the factors which indicate the ability of a political system to accommodate change without serious disruption, and,
- the factors which identify factions within a political system which may seek to cause disruption as a means of change, either on religious, political or ethnic minority grounds.

Both these groups of factors relate to the political stability of a country with particular reference to its prospects for the future, this being felt to be the main aim of any political analysis.

It is, however, pertinent to emphasize at this juncture that, during the 1970s when the level of international lending substantially increased, the incidence of ultimate loss from state risk lending was minimal. This cannot reasonably be attributed to a high level of political stability during this

period. Rather, experience has shown that no country can completely isolate itself from world events and that whatever local circumstances may prevail, it must maintain certain standards which include the honoring of international commitments if it wishes to continue to enjoy commercial links with other states and institutions. A recent example as far as the commercial banks are concerned is Iran. It has repaid the majority of its international debts although it is recognized that certain other obligations remain outstanding.

The question may, therefore, be asked: in what way is the analysis of political stability generally relevant and necessary within a country risk assessment system?

The question need not infer that political analysis is totally without use but implies, as in the case of the qualitative economic indicators, that the aim of any system may be not so much to avoid situations of absolute default but to identify and hence minimize the risk of temporary disruption and of rescheduling.

Systems Used to Combine Economic and Political Indicators

One of the main problems associated with these methodologies is how to combine the two elements in one assessment, and in this regard, the inter-relationship that inevitably exists must be borne in mind.

This inter-relationship means that, in combining economic and political factors into an overall country score, care must be exercised not to recount, under political variables, those already fully reflected in the economic score.

Commercial banks have not been deterred, however, from seeking systems which take into account both types of factors in establishing an overall rating.

In analyzing the manner in which the systems used by banks combine economic and political indicators to arrive at a country risk rating, it is interesting to note that all the systems surveyed gave details of economic factors used in the systems but only eight gave details of political influences.

The manner in which credit risk assessment is practiced in any one of the institutions surveyed is influenced by the following factors:

- a) the size of the institution and the level of expertise;
- b) the involvement of the institution in the international lending market:

The nature of the analysis undertaken has inevitably meant that it has concentrated on larger institutions with significant presences in the international lending market. Because of this, it was to be expected that the com-

mercial bank systems reviewed would exhibit relatively high levels of sophistication.

The majority of banks have concluded that an approach combining statistical analysis with a more descriptive method, and covering both economic and political factors is best suited to their needs. This method, known as a "structural/qualitative" approach, recognizes the limitations of both a purely statistically based system ("checklist" approach) and the shortcomings of the much looser "unstructured" approach or the exclusively "qualitative" approach.

The Place of the System in the Decision-Making Process

The Aim of the System

The general aim of the banks whose systems were reviewed has been to produce a system capable not only of identifying possible future defaults or reschedulings but also to aid the evaluation of the risk/reward relationship of any particular country. As already indicated above, this latter aspect is particularly relevant in the formulation of a commercial bank's marketing strategy.

Thus, as well as being one of the management tools used when assessing individual loan propositions, a country risk assessment system has an important role in the setting of country limits and the making of investment decisions. However, other important factors need to be taken into account such as the rate of return, strategic marketing decisions and lending portfolio considerations.

Whilst it is self-evident, it is important to stress that, for a risk assessment system to achieve its objectives, those operating the systems must fulfil these three conditions:

- they must possess an in-depth country knowledge,
- they must have a full awareness of those factors inherent in a successful country risk assessment system,
- they must possess the expertise necessary to identify and use the relevant data and, equally important, they must be able to analyse and interpret the conclusions in a constructive and balanced manner.

Other Considerations

Before examining other factors which will influence country risk assessment, it is worth noting that the systems reviewed are more applicable

to the major international banks. It is nevertheless essential that all banks arrive at an independent judgment on all syndicated lending decisions and in this connection, lead managers generally incorporate into loan agreements a clause stating that participating banks are solely responsible for undertaking their own independent appraisal of the risks appertaining to a loan.

Some other considerations relevant to the risk/reward relationship are:

- the frequency with which a borrower approaches the market,
- the skill of the negotiators — both lenders and borrowers,
- a commercial bank's existing exposure to a particular country and its need to maintain a balanced lending portfolio. Indeed this is one of the crucial factors and the principles of balance will be maintained irrespective of the assessment of country risk.

Future Prospects

The early 1970s was a period of growth in the Euromarkets and, during this time, as the number of banks involved in this sector increased and international liquidity expanded, most countries were able to fund even debt servicing by expanded borrowing. If this was not possible, countries were able to reschedule their loans in all except the very worst cases. As a result of these conditions, and the attendant low level of losses, there has been little apparent urgency to develop sophisticated systems because it has been possible to operate successfully without any formal system for minimizing country risk other than a balanced lending portfolio.

In more recent years, however, the influences of diminishing margins, at least in terms of prime borrowers, the slow down in the rate of growth which reduces demand from the corporate sector in the industrialized countries, and increasing competition for loans to the "better risk" developing countries, have combined to force banks looking for profit to turn towards "second tier" borrowers. This has occurred at a time when, for many countries, conditions have been worsening as the impact of rising oil prices, falling commodity prices and high interest rates has been felt.

There is no evidence that this trend in events is likely to alter dramatically. Banks are now being required to manage greater risk in their portfolios, and to seek more aggressively for satisfactory returns. It may, therefore, be expected that country risk analysis will continue to increase in importance.

Nevertheless, the quality of any system of analysis will still be dependent upon the standard of information which is input. In this regard, the World Bank, for example, is continually seeking to upgrade its information on countries' debt.

This is not to say that systems will necessarily monitor more variables: rather, that the standard of forecasting and understanding of each variable's significance should become better developed. There could also be a move towards more sophisticated models based on covariance at least for asset allocation purposes. This will involve a global approach to country risk, evaluating world events in terms of their overall effect on a portfolio of borrower countries.

Key Factors in Future Risk Assessment

Since Cuba and Ghana in the 1960s, no major borrowing country has deliberately repudiated its international debt, and this has led to the assumption, which was previously alluded to in this paper, that economic factors are paramount in assessing country risk. It may be that this assumption will gain further support and possibly, in future years, systems should focus even more on the economic factors. This is not to say that in future there will be a dramatic slackening in the pace of state risk borrowing.

The view is not, however, universally held, and it is not impossible that changes of regime in certain developing countries could conceivably lead to a repudiation of debts incurred by previous administrations.

Indeed, in view of the comparative sophistication in economic modelling and the fact that current political assessments are adequate for most normal situations, it could be that this aspect of unpredictable repudiation of debts could become the greatest absolute threat to international lenders in the future. An ability to assess this kind of risk will depend on an enhanced level of political analysis, including major studies of opposition groups in many countries.

When undertaking state risk lending internationally, banks expect to be repaid on schedule either by the borrower generating sufficient foreign exchange or by refinancing its debt. In a large number of countries, the level of external debt is relatively small in terms of the overall size of the economy and, therefore, repayment or refinance presents little problem.

However, if balance of payments deficits persist in certain instances the level of external debt and the burden of debt servicing will continue to increase and will become major problems. In cases such as this where, at the current time, a country is experiencing difficulty in servicing its debt from foreign exchange earnings, its ability to refinance existing debt depends upon it being seen to be moving progressively towards the required level of foreign exchange earnings. Therefore, it is at least arguable that future risk assessment systems should develop further the capacity to monitor countries' progress in this respect.

NOTES

Definitions Relating to Country Risk Assessment Systems

UNSTRUCTURED APPROACH

This approach involves no systematic or regular analysis of a country's position but relies upon opinions held on each occasion when a decision as to the creditworthiness of a country is required. There is no attempt made to 'rank' countries or to assess relative risk/reward ratios.

CHECKLIST APPROACH

This approach involves using a 'scoring' technique to scale a country's performance with respect to prespecified variables. It is quantitative in character and suffers from the exclusion of other variables which may have relevance to the overall assessment.

QUALITATIVE (OR DESCRIPTIVE) APPROACH

This system, based on country evaluation reports which vary in detail from country to country, focuses on each country's unique attributes and problems. The principal disadvantage is that evaluation may vary substantially between countries making comparisons difficult. Moreover, evaluations tend to be retrospective rather than prospective.

THE STRUCTURED/QUALITATIVE APPROACH

This approach uses a standard format for all countries, thus facilitating comparison, it covers both political and economic factors and involves a degree of statistical analysis where appropriate. Because it relies not only on statistical data but also on expert opinion it is able to combine the advantages of the Qualitative with statistically based methods such as the Checklist Approach.

COVARIANCE

This will involve a global approach to country risk, evaluating world events in terms of their overall effect on a portfolio of borrower countries. For example, an oil price rise, whilst of benefit to OPEC countries, has a detrimental effect on the non-oil LDC's.

ECONOMIC FACTORS

COMMERCIAL BANKS' ATTITUDE TO COUNTRY RISK ASSESSMENT

SCHEDULE OF FACTORS USED IN THE INDIVIDUAL SYSTEMS REVIEWED AT APPENDIX II

Measure	A	B	C	D	E	F	G	H*	I	J*	K
Debt service ratio	X	X	X	X	X		X	X	X	X	X
Imports/Reserves ratio	X			X		X		X	X		X
Capital/Debt ratio	X			X		X		X		X	
Income per capita	X	X	X	X				X	X	X	X
Income growth rate	X	X	X		X	X	X	X	X		X
Export growth rate	X		X	X	X		X	X	X		X
Export analysis		X	X		X	X	X		X	X	X
Imports/Exports ratio		X	X	X		X	X		X		X
Economic diversity		X	X			X			X		X
Exports/GNP		X	X	X						X	X
Level of IMF support/Reserves ratio		X		X	X	X	X	X	X		X
Debt structure		X		X			X	X	X	X	X
Inflation/Monetary/Fiscal policy		X	X	X	X	X	X	X			X
Physical resources			X	X		X	X	X	X		X
Debt			X	X		X	X	X	X	X	X
Import analysis			X	X	X		X	X		X	X
Basic strength		X	X	X			X				X
Ability to change peacefully		X		X		X	X	X			X
Likelihood of internal conflict		X		X		X	X	X	X		X
Policies of ruling group		X	X			X					X
Philosophy of ruling group		X									X

POLITICAL FACTORS

COMMERCIAL BANKS' ATTITUDE TO COUNTRY RISK ASSESSMENT

SCHEDULE OF FACTORS USED IN THE INDIVIDUAL SYSTEMS REVIEWED AT APPENDIX II

Ability of government officers	X	X	X	X	X
Flexibility of the political system	X		X		
External relations	X	X			
Minority groups	X		X		
Religious problems	X		X		
Unemployment	X		X		
External ethnic problems	X			X	
Government support				X	
Type of system				X	
Opposition groups			X		
Wealth disparity				X	

~ In some cases similar measures from two or more systems are grouped together under one heading. For example, "Income per capita and Income growth" are taken in terms of either GNP or GDP

* Systems H and J allude to a comprehensive political analysis but factors are shown above only where detailed in the articles.

KEY TO THE SYSTEMS REVIEWED:

- A Feder/Ross: World Bank (G. Feder and K. Ross) 1977
- B C.M. Korth, University of South Carolina, Ex First National Bank of Chicago 1979
- C J.N. Robinson, Chase Manhattan Bank NA (1981)
- D K. Janoeri, Union Bank of Switzerland (1980)
- E Amsterdam and Rotterdam Bank NV (1980)
- F Business International Country Risk Assessment Service (1981)
- G P.S. Nagy, Bank of Montreal (1978)
- H H.R. Heller, Bank of America (1980)
- I P. Gutman, National Westminster Bank Ltd. (1980)
- J American Express Bank (1980)
- K A. Von Agtmael, Bankers Trust Co. (1976)

List of Systems Studied

1. *Authors:* G. Feder and K. Ross, Economists at the World Bank
Article: Quantitative Creditworthiness Indicators are useful
Publication: World Bank Publication.
Date of Publication: December, 1977
Aim: To quantify the probability that a country will reschedule at least part of its foreign debt in some future year.
Indicators reviewed: Economic only
2. *Author:* A.W. von Agtmael, Vice President Bankers Trust Co. and Managing Director (designate) Thai Investment & Securities Co., Bangkok
Article: Evaluating the Risks of Lending to Developing Countries
Publication: Euromoney
Date of Publication: April, 1976
Aim: To analyse country risk from the point of view of a commercial bank making term loans to *developing* countries.
Indicators reviewed: Economic and Social/Political
3. *Author:* C.M. Korth, Associate Professor of International Business, University of South Carolina (formerly Credit Analyst, First National Bank of Chicago).
Article: Developing a Country Risk Analysis System
Publication: Journal of Commercial Bank Lending
Date of Publication: December, 1979
Aims: To minimize the risk in a bank's foreign portfolio. (Risk in this instance includes default, moratorium, forced rescheduling or excessive delays in repayment of principal or interest on a national scale).
Indicators reviewed: Political/Socio-Cultural and Economic.
4. *Author:* P. Gutman, Manager, Market Intelligence Department, National Westminster Bank
Article: Assessing Country Risk
Publication: National Westminster Bank Review
Date of Publication: May, 1980
Aims: To provide an assessment and classification of foreign countries from the point of a commercial bank involved in international lending.
Indicators reviewed: Political and economic
5. *Author:* J.N. Robinson, Senior Economist, Chase Manhattan Bank
Article: Is it Possible to Assess Country Risk?
Publication: The Banker
Date of Publication: January, 1981
Aims: To identify countries which will fail to generate enough foreign exchange to service their foreign debt.
Indicators reviewed: Economic and Political/Legal
6. *The Business International System (BI)*
Authors: Business International
Article: Business International Country Risk Assessment Service
Article: Business International publication
Date of Publication: 1981

- Aims:* To identify and quantify country risk in a system designed to meet the widest range of corporate planning and forecasting needs.
Indicators reviewed: Political, economic and financial
7. *The Amex Bank System*
Authors: Amex Bank Economics Unit
Article: Country Risk Analysis and Decision Making in an International Bank. The Approach at American Express International Group
Publication: Amex Bank Economics Unit publication
Date of Publication: January, 1980
Aims: To provide quality analysis of country risk, using all available resources and to thereby improve the bank's spread of assets world-wide.
Indicators reviewed: Economic and Political
8. *Author:* P.J. Nagy, International Economist, Bank of Montreal
Articles: a) Country Risk-How to Assess, Quantify and Monitor It
 b) Quantifying Country Risk-A System Developed at the Bank of Montreal
Publications: a) Euromoney Publications
 b) Colombia Journal of World Business
Date of Publications: a) December, 1978 b) Autumn, 1978
Aims: To quantify country risk by comparing the risks of investing in nations among which size, levels of economic development and political and institutional structures differ.
Indicators reviewed: Economic and Political
9. *The Amro Approach*
Article: Country Risk Analysis & Lending Policies — The Amro Approach
Publication: Amro publication
Date of Publication: February, 1980
Aims: A model to assist in portfolio development with regard to risk, return and volume.
Indicators reviewed: Economic and Political
10. *The Bank of America System*
Author: H.R. Heller, Vice President, International Economics, Bank of America.
Article: Bank of America's New Currency Evaluation System. (AMR — Euromoney conference on country risk assessment).
Date: 30 October, 1980.
Aim: To analyse a country's capacity to service its foreign debt.
Indicators reviewed: Economic and Political
11. *Author:* K. Janjoeri, Senior Vice President, Union Bank of Switzerland
Article: Assessing Country Risk
Publication: UBS International Banking publication
Date of Publication: June, 1980
Aims: To provide an indication as to the creditworthiness of any country to whom UBS may choose to lend.
Indicators reviewed: Economic and Political

APPENDIX B

The Rescheduling of Country Debt: Is a More Formalized Process Necessary?

Richard Huff

Introduction

With the growing importance of commercial bank lending in international financial flows in the 1970s, it was inevitable that country debt service crises would take on a new flavor. The debt reschedulings that resulted from such crises were not new or unprecedented, of course. Reschedulings of official debt had become fairly commonplace ever since Argentina had asked its government creditors to reschedule in 1956; ten countries engaged in 31 separate reschedulings over the two decades 1956—75. Such multilateral exercises had, in fact, become fairly routine through the procedures of the Paris Club, an informal group of major Western creditor governments chaired by the French Treasury.¹ And, while the rescheduling of debt owed to private creditors was less frequent, it was by no means unheard of; several countries — including Argentina, Brazil, and Chile — had rescheduled their private debt in the 1960s and early 1970s.

What distinguished the reschedulings of the later 1970s, then, was not so much their novelty as their scope. Instead of the relative handful of banks, often from a single country that once had been involved in negotiations, there were now 100, 200, or more. (Poland is currently attempting to reschedule debts owed to some 500 separate institutions.) And where a few million dollars were once at issue, the stake had grown to the hundreds of millions, or, in some cases, billions of dollars.

This increase in the scale of the reschedulings suggests a corresponding increase in their complexity — a complexity manifested both in the substance of the talks as well as the mechanics of a process involving so many participants. And it calls into question whether the ad hoc approach that has previously been taken toward the organization of these negotia-

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tions will continue to be effective in the reschedulings of the '80s. That approach, to be sure, has thus far been adequate to the demands placed upon it. No rescheduling talks have failed simply because of organizational difficulties in starting a new rescheduling process from scratch each time that banks and debtor governments decide to enter into negotiations. And the flexibility afforded by the absence of a more formalized process has perhaps aided in the resolution of difficult substantive issues. But "ad-hocery" has had its costs — notably the confusion and delay in resolving difficult organizational and procedural questions before substantive discussions can begin. And if reschedulings become more numerous and frequent in the years ahead — as many observers predict — it is well worth considering whether the process for conducting them ought to be more formalized and institutionalized.

This paper will examine that question. We will begin with a review of the rescheduling experience of the past half-dozen years, focusing in particular on whatever recurring problems and difficulties have arisen. The paper will then consider the coordination of commercial debt rescheduling with the renegotiation of official debt and the appropriate role of the International Monetary Fund. It will conclude with a brief discussion of possible improvements in the present rescheduling process.

The Rescheduling Process

Getting to the table. A recent IMF staff study² examined the cases of six IMF members that rescheduled their obligations to commercial banks between 1976 and 1980. It noted that the rescheduling process was generally a long and difficult one, taking from two to five years from the time a debt service problem first emerged until an agreement was actually signed. Generally, negotiations did not begin until one or two years after such signals as the emergence of arrears or the reluctance of banks to roll over maturing credits might have suggested that a rescheduling would be necessary; once begun, the talks themselves took anywhere from 18 months to four years to complete.

One of the difficulties the parties to these negotiations faced surely was the lack of a well established means of resolving their differences. "While the modalities for the restructuring of official debt were fairly well established," comments the IMF study, "the restructuring of debt owed to commercial banks involved, to a large extent, the breaking of new ground." Previous commercial debt reschedulings had concentrated on the restructuring of short-term trade credits, but now the focus was on medium-term syndicated Eurocredits, which brought a host of complications. The hundreds of banks of many different nationalities involved in the various loan syndications had to be contacted. Basic data on how much was owed to

whom had to be collected, information that was not always readily available. (One country, which had not kept its records particularly well, had to resort to sending out a questionnaire to its creditors to find out exactly how much it owed.) And in four of the six cases covered in the IMF paper, the negotiations had to be coordinated with parallel discussions with official creditors, who insisted that private and official debt be rescheduled on "comparable terms."

Ultimately, though, despite such obstacles, the negotiations in each of the six cases were successful — at least in the sense of an agreement being reached and signed. (Whether the debtor countries will actually be able to adhere to the terms of these agreements is, of course, a separate question.) The actual hard bargaining was done by a steering committee of a half-dozen or so lead banks on the one side and representatives of the debtor nation (often assisted by investment bankers acting as advisers) on the other. Also playing key roles in the talks, generally as advisers rather than as active participants, were officials of the IMF, and, to a lesser extent, the World Bank. The members of the steering committee were generally chosen from the lead managers and agent banks of the syndicates that had lent money to the country; usually, these banks were the ones with the largest individual exposures. Additionally, steering committee members were chosen on the basis of country representation, so that a bank from each of the major creditor countries was present.

Interbank tension. After the steering committee members were chosen, they faced the sometimes-daunting challenge of forging a common negotiating position for all of the creditor banks. Interbank politics have been one of the more important factors influencing the course of rescheduling negotiations, yet one of the less well understood. One reason for interbank discord, beyond the normal commercial rivalries of this intensely competitive business, has been the fear that debt relief advanced by one creditor might simply be used to pay off someone else, thus leaving the debtor's financial position unchanged. Once a debt-servicing problem develops, creditor banks naturally want to reduce their exposure in the debtor country. They may be willing to go along with efforts to float new loans or reschedule old ones to allow the country more time to work out its problems, but only as part of a joint effort of all the country's creditors. And they are decidedly unwilling to increase their own exposures only to reduce that of someone else. Thus the doctrine of "fair treatment" has emerged as the guiding principle of debt-restructuring negotiations: each bank is expected to participate in debt relief (either new funding or rescheduling) in proportion to its existing exposure. The enforcement of that doctrine, however, is no easy matter. Short-term trade financing is generally not covered, and often banks have sought to reduce their exposure by allowing

such credits to expire, thus exacerbating the debtor's foreign exchange shortage and debt-servicing difficulties.

Also contributing to interbank tension have been differences of opinion over the terms that should be offered to the debtor country, with some banks favoring a hardline approach while others adopt a more generous posture, in the belief that the debtor should be given more room to maneuver. In some cases, such divisions follow national lines, with U.S. banks favoring one position and German or French banks another, for example. At other times, however, banks divide up on the basis of size, with large banks adopting one posture and small banks another. Negotiating postures are often influenced by expectations of future business with the debtor country, with banks that hope to do a lot of business taking a more conciliatory attitude than those that do not. Negotiating positions are also influenced by the size of each bank's exposure, reflecting the old adage that a large enough debt turns a creditor into a partner. Further, bank negotiating positions are sometimes determined by the personnel that each chooses to send to the bargaining table with country lending officers — whose basic orientation is toward selling future loans — tending to take a softer line than, say, credit review officers.

A final source of interbank tension is the danger that one or more banks will break rank and strike a separate deal or will attempt to have the debtor nation declared in default and its external assets attached. Because of the cross-default clauses included in most loan syndications, even one such default declaration could set off a chain reaction of defaults, leading to a massive legal tie-up that could take years to unravel. Still, the probability of such a disaster should not be overestimated. Declaring default would only make sense if the initiating bank held deposits from the debtor country sufficient to cover its outstanding loans, but the deposits and other foreign assets of countries in debt service difficulty are generally only a small fraction of their total obligations. In addition, such a bank would be considered a pariah by its peers and could find its access to other international business reduced.

Country advisers. When Indonesia's state-owned oil company Pertamina ran into financial difficulty in 1975, the Indonesian central bank called in three investment banks to assist the troubled company work out its debts with its foreign creditors. The three — Kuhn Loeb of New York, S.G. Warburg of London, and Lazard Freres of Paris — later formed a consortium to provide financial advisory services to other developing countries; their clients have included Zaire, Turkey, Gabon, and Sri Lanka. Similarly, Morgan Grenfell has advised Sudan and Oman.³

In past reschedulings, these firms have assisted their clients by pulling together the data on how much they owed and to whom, by advising them

on the terms they might reasonably expect from the banks and, in some cases, by actually negotiating on their behalf. But though such services have greased the wheels of the rescheduling process, the investment bankers' role has drawn a good deal of fire from the commercial bankers' side of the table. While applauding the investment firms' assistance in reorganizing and consolidating their clients' debt service accounts (which, in some cases, were in shocking states of disarray) and in toning down the debtors' more unrealistic demands, some commercial bankers fear that, by interposing themselves between debtor and creditor, the investment advisers will inhibit the development of the confidence and trust necessary in such situations. In addition, these bankers believe that the investment firms will attempt to duplicate the terms won for one country for all of their other clients, with the result that rescheduling will become less flexible, more concerned with precedent, more legalistic and more adversarial. Naturally, the investment bankers dispute these contentions, arguing that the debtor countries have every right to expert financial counsel, just as they have to top-flight legal advice.

Relationship to Official Rescheduling

In four of the six cases covered in the IMF study, the debtor nation also negotiated a multilateral rescheduling of official debt under the auspices of the Paris Club. In these cases, creditor governments insisted on the principle of "comparable treatment" of other creditors. Like the banks, they did not want to grant debt relief only to see it used to bail out someone else — particularly when the "someone else" was a private commercial bank that had extended credit presumably in full awareness of the risks of nonpayment. Nonetheless, a comparison of the terms of the private and official reschedulings reveals that the official creditors were somewhat more generous. This primarily reflects the fact that private loans carry variable interest charges at market levels, while rates on official loans are fixed and below-market. However, official creditors were also more willing to re-schedule interest in arrears and resume lending once the agreement had been signed. The banks, by contrast, reflecting their quite different motivations for lending, were understandably more reluctant to return to "business as usual" until the debtor's creditworthiness markedly improved.

Role of the IMF

In each of these six cases, the staff of the International Monetary Fund provided technical support to the negotiations. The IMF provided the banks with information on the debtor nations' economic outlook and payment prospects; this was done in an informal manner, either by telephone or in meetings between bank officials and Fund personnel. The IMF also aided

the countries involved in preparing for their negotiations with the banks, particularly in those cases where the lack of reliable statistical data was an important problem. In four of the cases, IMF staff members sat in on discussions between the banks and the countries, and on one occasion, when talks were at an impasse, the IMF played a more active role by trying to mediate the dispute.

In each instance, the banks suggested that the debtor country negotiate an upper credit tranche program with the IMF. Such programs were important to the banks not so much for the hard currency provided but as signs that the countries had embarked on the road to recovery. In five out of the six cases, such a program was in place at the time the rescheduling agreement was signed, with the disbursement of new funds or the consolidation of existing obligations being made contingent upon the country's compliance with the terms of its IMF arrangement.

The flow of information between the IMF and the banks has not been strictly one-way, however, since the IMF needs to know the magnitude of expected private capital flows, including debt relief, in devising a realistic adjustment program for countries with payments problems. In some cases, the IMF has even offered its suggestions to the banks on what would be an appropriate amount of debt relief, in one case playing an "active role" (the words are from the IMF staff study) in assuring that the banks in fact provided the targeted level of assistance.

The reschedulings of Peru's and Nicaragua's debts illustrate both the importance and limits of the IMF's role. In 1976, before Peru had begun talks with the IMF, the banks agreed to a \$400 million balance of payments support loan conditional upon the government's compliance with its announced stabilization program. That program had been drawn up at the request of the banks and strongly resembled standard IMF orthodoxy, although the IMF was not involved in either its design or its execution. The banks soon found, however, that they were unable to monitor the program in the manner of the IMF; they had neither the expertise nor the standing to do so. Peru's performance quickly diverged from that promised by the program, and the banks were forced to cancel the second \$200 million installment of the loan. At that point, the IMF was called in.

The lack of IMF participation in the Nicaragua talks reflected the unusual political circumstances surrounding those negotiations, which help, in part, to explain the unusually favorable terms that resulted. The IMF had begun talks with the Somoza government on a stabilization program in 1978; the two sides reached agreement, in fact, only a few weeks before that regime fell in 1979. After their accession to power, the Sandinistas renounced the agreement and would have nothing further to do with the Fund, despite the devastated state of the Nicaraguan economy and its need

for foreign exchange. Nicaragua was able to succeed in shutting out the IMF, however, only because of the donations, soft loans, and central bank deposits it received from other governments and multilateral institutions — the World Bank and Inter-American Development Bank in particular. With its foreign exchange coffers replenished, Nicaragua was able to avoid the need for an IMF agreement and was in a stronger bargaining position with the banks. The moral and financial support it received, however, was coupled with pressure to reach a rescheduling agreement. In this way, the "good offices" role normally performed by the IMF was filled instead by its sister institutions.

The absence of the IMF from the Polish rescheduling underscores the need for a process flexible enough to handle situations involving non-IMF members. Unfortunately, the institutions that stepped into the breach in Nicaragua were unable to do the same in Poland, and no other intermediaries have yet appeared.

Alternatives to the Present Process

Those who are concerned over the adequacy of the present system (or lack thereof) often express their preference for a more formalized, institutionalized process, perhaps under IMF auspices. The Fund is probably the most logical institutional home for such a mechanism, in light of its pivotal role in balance of payment adjustment cases. However, if a commercial bank rescheduling mechanism were to be set up under the IMF umbrella, several important obstacles would have to be overcome. Not the least of these are the somewhat skeptical attitudes toward the IMF of both parties to rescheduling negotiations. Debtor countries may view the Fund as a collection agent for the commercial banks, while many bankers, for their part, believe that the Fund is ultimately answerable to its member governments and is thus biased toward the interests of the debtor. In any event, private creditors will probably be wary of surrendering any of their legal claims to a supranational arbitration body, however (and wherever) institutionalized.

Another possible institution that could aid in rescheduling negotiations is the suggested International Banking Consultative Group (described on pp. 33 through 35).

Whatever procedures for rescheduling are ultimately decided upon, or simply evolve, it may be useful to anticipate them at the time loans are originally extended by incorporating the appropriate clauses in the loan documentation. Such language would have the advantage of specifying in advance the conditions under which rescheduling would be appropriate and how the talks should be conducted, thereby reducing the costly delays usually associated with getting the negotiations underway. The other side of

such specificity, however, is the loss of the flexibility of the current process. In addition, such clauses would of course not be binding upon the parties to other loan syndications not including them; they might, therefore, be rendered inoperative if these other creditors did not agree to them.

Conclusion

Procedural reforms will not, of course, avert the difficult financial problems which lead to reschedulings. But the prospect of such problems underscores the importance of procedures intended to avoid their less desirable effects. The likelihood of continued large payments deficits and the possibility of debt service problems in major debtor countries suggest that rescheduling will be a recurring feature of the international financial system of the 1980s. If so, participants in that system may wish to alter the process of rescheduling so as to improve its probability of success, either by the proposals offered here or by some other, as yet unsuggested, reforms. Reforms of the rescheduling process should thus be a matter for active consideration.

¹ Occasionally, these governments met in the Hague or London; sometimes they styled themselves as OECD or IBRD consortia. Despite the variance in place and name, however, their basic structure and function was analogous to that of the Paris Club.

² Bahram Nowzad, Richard C. Williams, et al., "External Indebtedness of Developing Countries," Occasional Paper No. 3, International Monetary Fund, Washington, D.C., May 1981. This note draws heavily on information contained in the IMF study and two other recent papers (A Porzecanski, "The Assessment of Country Risk: Lessons from the Latin American Experience," in Garcia-Zamor and Sutin, eds., *Financing Development in Latin America* (NY: Praeger, 1980); and L. Brainard and T. Trebat, "The Role of Commercial Banks in Balance of Payment Crisis — The Cases of Peru and Poland," presented to the International Conference on Multinational Corporations in Latin America and Eastern Europe, March, 1981) as well as the case studies of Nicaragua and Turkey presented to the Study Group and recent material from the press and trade journals.

³ See Anthony Sampson, *The Money Lenders* (New York: Viking Press, 1982), pp. 218—220.

APPENDIX C

Trends in Eurocurrency Credit Participation 1972-1980

Diane Page and Walter D. Rogers

The burgeoning Eurocurrency credit market exceeded \$70 billion in publicized volume in 1980, compared to \$9 billion in 1972. Today, the bulk of publicized Eurocurrency lending is done by bank syndicates rather than individual institutions. Although the financial press annually allocates syndicated Euroloan volume among managing institutions, identifying the world's top Eurolenders, no one has documented the steady influx of new loan participants into the Eurocurrency credit market or comprehensively considered the changing nationality of participants over time. Using World Bank data, Office of the Comptroller of the Currency staff were able to examine these non-volume indicators of the increasing breadth of the publicized Eurocurrency credit market.¹

Analysis of the World Bank data shows that a relatively constant average of 66 independent financial institutions became first-time entrants into the Eurocurrency credit market each year between 1973 and 1980. By 1980, nearly 400 independent financial institutions were active in the market. In the earlier years, the new entrants were largely European and North American banks and international consortium banks. More recently, Latin American, Middle Eastern and Asian institutions have entered the market in greater numbers. Further findings from the World Bank data reinforce the well-documented expansion of Middle Eastern financial institutions into Eurocurrency lending. For example, in terms of number of participating institutions, Middle Eastern institutions have increased their presence in the market from less than one percent in 1972 to an eight percent share of the total in 1980. However, in every year, European and U.S. institutions ac-

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count for the bulk of total participating institutions as well as total loan participations.

Introduction

Analysis in this paper is restricted to publicized Eurocurrency credits. It examines financial institutions which were Eurocurrency loan participants between 1972 and 1980, considering their nationality, entry into the Eurocurrency market, and number of yearly loan participations.

Eurocurrency credits are loans and credit lines denominated in a currency other than that of the country in which the lending institution is located. Eurocurrency credits first appeared in the 1960s. At that time, they were almost exclusively fixed-rate loans to corporate borrowers underwritten by specialized investment banks, notably the British merchant banks, which later sold participations to other banks. The Eurocurrency credit market began to take on its present characteristics in the early 1970s. Loans became floating rate instruments. Nations began to finance balance of trade deficits through Eurocurrency borrowings. And the world's large international commercial banks began managing large Eurocurrency credits through syndications. Syndication of credits reduced risk for the underwriters and brought together the large resources necessary to finance sovereign debt. With successive oil price increases in 1973 and 1974, the oil-producing nations developed trade surpluses while non-oil-producing less-developed countries faced growing deficits. The Eurocurrency credit market began to serve a vital function as a recycling mechanism, moving surplus capital from the oil-producers to the non oil-producing nations. Publicized Eurocurrency credits reached a volume of \$70.4 billion in 1980, according to World Bank data. Publicized credits, which are medium- to long-term and usually syndicated, represent only a portion of international borrowing. It has been estimated that one-half of Eurocurrency bank lending is short term, unpublicized lending used for private trade and international business financing.² International and foreign bond issues are another vehicle for international borrowing, and accounted for \$41.8 billion in 1980.³

Description of the Data

Data collected by the World Bank cover publicized borrowing in international capital markets in the form of Eurocurrency credits between 1972 and 1981.⁴ Notice of Eurocurrency credits appears in a published announcement known as a tombstone. The tombstone generally contains the name of the borrower, the amount of the credit, and the names of the financial institutions which participate in the loan. Often, but not always, Eurocurrency credits are led by a single large institution. Smaller volume

credits are less likely to have a lead manager, while some loans have two or more co-lead managers. The lead manager receives a mandate from the prospective borrower to raise funds and seeks to put together a managing group.

The lead manager typically underwrites the entire amount of the credit, making a commitment to provide the funds before arranging the syndication. On the tombstone, institutions are usually listed in order of the size of the participation they take in the loan. As a rule, the lead manager is listed

Table I
Eurocurrency Credit Aggregates
1972-1980

Year	Loan Volume (\$ billions)	Total # Loans	Total # Participations	% Loans with Unnamed Participants	% Participations By Unnamed Participants
1972	8.8	258	415	1	1
1973	20.8	402	725	1	1
1974	28.5	474	1027	1	1
1975	20.6	418	1482	5	6
1976	28.7	430	1827	8	9
1977	34.2	489	2360	10	10
1978	73.7	786	3781	15	20
1979	70.2	813	4329	16	22
1980	70.4	797	4913	18	24

Source: World Bank data.

* A small percentage of participants are listed as "syndicates" and thus actually represent more than one institution.

first, followed by managers, co-managers, and participants, which take successively smaller portions of the loan. When institutions are listed in alphabetical order, this generally indicates that each participant has taken an equal participation. Sometimes institutions are listed in alphabetical order within manager, co-manager and participant sub-groups.

Computerized World Bank data identify by name a maximum of ten participants per individual Eurocurrency credit in order of their appearance on the tombstone. When a loan has more than ten participants, nine participants are identified by name and the number of additional, unnamed participants is indicated. Since these additional participants are not identified, there is no way to ascertain how many individual institutions participated in all loans in each year. However, it is possible to aggregate the total number of named and unnamed *participations* for all loans in each year, and likewise to determine how many loans had unnamed (more than ten)

participants. As shown in Table I, an increasingly significant proportion of total loan participations, 24 percent by 1980, have been taken over time by participants not identified by name in the World Bank data. The number of loans with unnamed participants increases to 18 percent of total loans by 1980. The reader should bear in mind that, in most of the following discussions of participant nationality, new entry and loan participations, only named participants, those who took the first nine or ten listed positions on each loan, are considered. It was not possible to identify the unnamed participants or to draw any conclusions about their entry trends or nationality patterns.

In the following analysis, information has been provided on those institutions appearing as first listed participant for each loan in the World Bank data, i.e., institutions listed first on the loan tombstones. Although this information provides some indication of the nationality distribution of lead managers, it should be interpreted with caution. As explained above, lead managers usually appear first on the publicized loan notices. However, since some credits have no lead manager, some credits have a number of co-lead managers, and some tombstones list all participants alphabetically, first participant position in the World Bank data is not a perfect proxy for lead manager. (World Bank staff estimate that about 20 percent of the Eurocurrency credit tombstones list participants alphabetically.)

Nationality of the named participants is not included in World Bank data and was determined using a variety of almanacs, yearbooks and other reference sources. Institutions were grouped by nationality of ownership rather than country of charter; Euroloan activity of branch offices or subsidiary companies has been credited to the head office or parent institution. For example, Deutsche Bank AG, Deutsche Bank AG (London), and Deutsche Bank Cie. Fin. Luxembourg were all considered part of a single German financial institution when determining the number of German Euroloan participants, German entry into the market, and the number of German loan participations.

Results

Between 1972 and 1980, the number of publicized Eurocurrency credits tripled from 258 to 797 and their combined volume increased from \$8.8 to \$70.4 billion, according to World Bank data (see Table I).⁵ The following analysis is based on a direct comparison between Eurocurrency credit activity in 1972 and 1980, since changes between 1972 and 1980 reflect trends which characterize the intervening years. However, the figures are also affected by specific factors such as the slowdown in U.S. Eurolending dating from 1979 and government restrictions on foreign lending of Japanese banks in 1980. (See Appendix tables.)

Number of lenders

The number of named loan *participants*, consolidated into parent institutions, nearly tripled from 133 to 386 between 1972 and 1980. Figure I shows a geographic breakdown of these institutions in 1972 and 1980.⁶ (Consortium banks were placed in the Asian, European and Middle Eastern categories when their owning institutions were identified as all Asian, all European or all Middle Eastern.) The absolute number of managers in all geographic categories increased, but relative shares of the total changed over time. The predominance of European institutions, well over one third of the total in both years, is evident, as is the growing importance of the Middle Eastern institutions, which represented less than one percent of the total share in 1972 and 8 percent in 1980. The share of U.S. and Canadian institutions, on the other hand, dropped by ten percent of the total, while the share of Asian institutions dropped by five percent of the total.

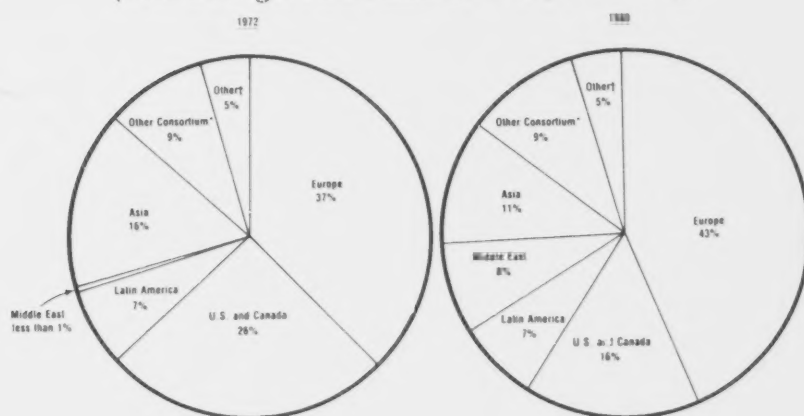
New entry

Between 1973 and 1980, 526 parent institutions which had not participated in any previous year for which data are available entered the Eurocurrency credit market. The number of new entrants is relatively constant, averaging 66 per year (Figure II).

Figure I

**Nationality of Parent Financial Institutions Participating in the
Publicized Eurocurrency Credit Market
1972 & 1980**

(First through Tenth Listed Participants Only)



Source: World Bank data

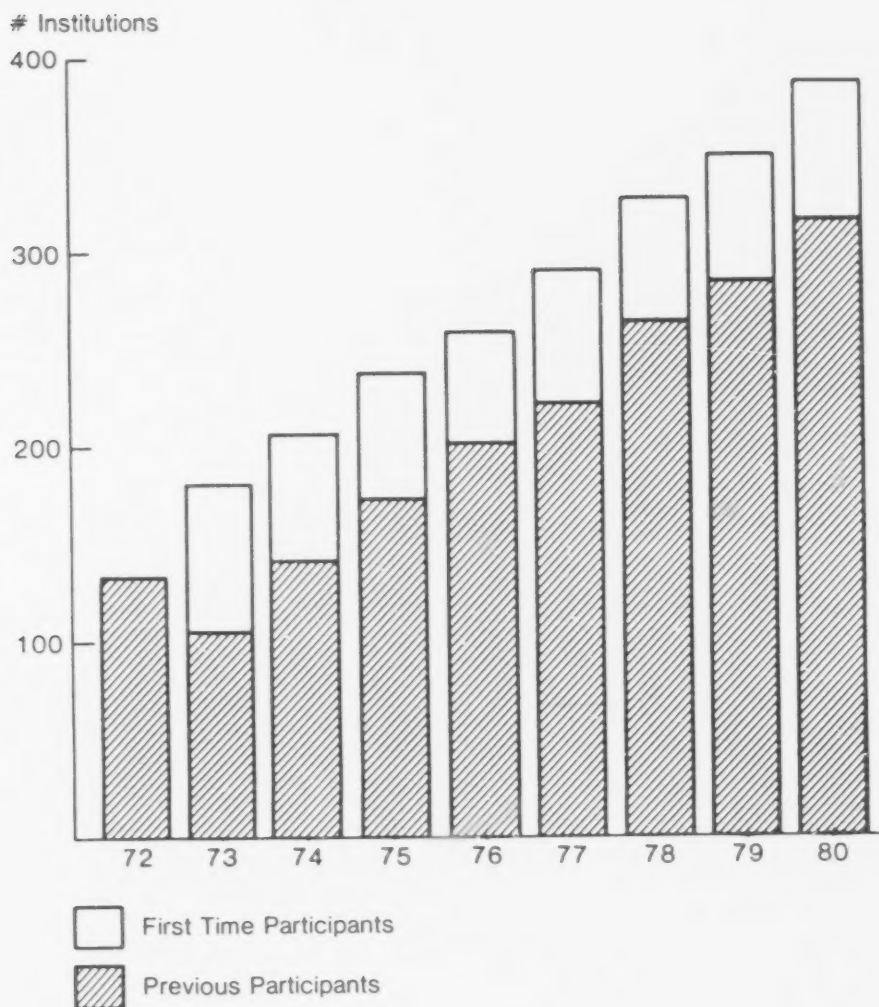
* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

Financial Institutions
Participating in the Euroloan Market
1972-1980
(First through Tenth Listed Participants Only)

	72	73	74	75	76	77	78	79	80
Austria	0	0	4	4	4	11	5	7	14
Belgium	4	3	3	5	4	3	3	4	4
Luxembourg	3	3	3	4	5	7	11	7	7
Fed. Rep. of Germany	5	7	10	13	13	17	17	22	21
France	9	15	14	16	15	17	17	22	19
Italy	3	5	6	5	8	9	18	12	15
Netherlands	0	1	3	4	5	5	5	6	5
Spain/Portugal	2	5	9	13	14	13	11	19	22
Switzerland	2	2	4	4	9	9	8	9	11
United Kingdom	18	24	20	18	19	18	18	19	18
Other, W. Europe	1	9	9	18	12	14	14	16	17
E. Europe	1	2	3	3	2	1	1	2	5
Total	48	76	88	107	110	124	128	145	158
Canada	3	4	7	9	7	9	9	10	9
USA	31	40	41	46	46	43	49	50	54
Total	34	44	48	55	53	52	58	60	63
Mexico/Central/S. Amer.	6	3	5	6	5	8	8	12	23
Caribbean	3	2	5	3	4	3	2	4	3
Middle East	1	2	3	6	11	17	25	23	25
Africa	1	0	1	1	1	2	1	2	3
Japan	17	21	17	7	13	18	24	24	24
Other Asia	5	2	4	5	4	9	11	16	19
Total	22	23	21	12	17	27	35	40	43
Oceania	2	0	1	2	1	1	3	5	8
Consortia	12	22	30	36	48	49	60	51	51
of which European	1	4	4	5	6	7	7	8	9
Arab	0	0	1	2	3	5	9	6	6
Asian	0	1	1	1	1	0	0	1	0
Other	11	17	24	28	38	37	44	36	36
Unidentified	4	6	5	7	6	5	7	5	9
GRAND TOTAL	133	178	207	235	256	288	327	347	386

Figure II
First-Time and Previous Participants in the Publicized
Eurocurrency Credit Market*
1972-1980



* Refers to first-time entry since 1972; data not available for previous years.

**Financial Institutions Entering the Euroloan
Market for the First Time***
1973-1980
(First through Tenth Listed Participants Only)

	73	74	75	76	77	78	79	80
Austria	0	4	1	1	5	1	0	5
Belgium	0	0	1	1	0	0	1	0
Luxembourg	0	0	2	3	3	3	0	2
Fed. Rep. of Germany	2	5	4	1	4	1	4	2
France	7	2	4	2	3	0	6	1
Italy	2	1	1	2	5	5	2	1
Netherlands	1	2	1	2	2	1	0	0
Spain/Portugal	3	4	5	2	1	1	6	7
Switzerland	1	2	0	5	3	1	3	2
United Kingdom	9	2	1	1	0	1	0	1
Other, W. Europe	8	3	9	3	1	0	0	1
E. Europe	1	1	1	0	0	0	0	3
Total	34	26	30	23	27	14	22	25
Canada	1	3	3	1	1	0	1	0
USA	13	9	10	7	5	7	6	10
Total	14	12	13	8	6	7	7	10
Mexico/Central/S. Amer.	2	2	0	0	3	3	3	10
Caribbean	0	2	0	0	2	0	3	1
Middle East	2	3	2	6	9	11	7	3
Africa	0	0	0	1	1	0	2	1
Japan	4	1	0	1	2	4	1	1
Other Asia	2	1	2	1	6	4	5	10
Total	6	2	2	2	8	8	6	11
Oceania	0	0	1	0	0	1	4	2
Consortia	13	14	13	14	7	15	6	5
of which European	3	0	1	2	1	0	1	0
Arab	0	1	2	1	1	4	0	1
Asian	1	1	1	0	0	0	0	0
Other	9	12	9	11	5	11	5	4
Unidentified	4	4	3	2	3	4	4	5
GRAND TOTAL	75	65	64	56	66	63	64	73

* Refers to first-time entry since 1972; data for previous years not available.

Table II
Nationality of Parent Financial Institutions Entering the Publicized
Eurocurrency Credit Market for the First Time*
1973-1980

Year	Nationality					Other	
	Eur.	N. Amer.	Latin Amer.	Asian	M. East	Consortium	Other
1973	37	14	2	2	7	9	4
1974	26	12	4	4	3	12	4
1975	31	13	0	4	3	9	4
1976	25	8	0	7	2	11	3
1977	28	6	5	10	8	5	4
1978	14	7	3	15	8	11	5
1979	23	7	6	7	6	5	10
1980	25	10	11	4	11	4	8
TOTAL	209	77	31	53	48	66	42

Source: World Bank data

* Refers to first-time entry since 1972; data not available for previous years.

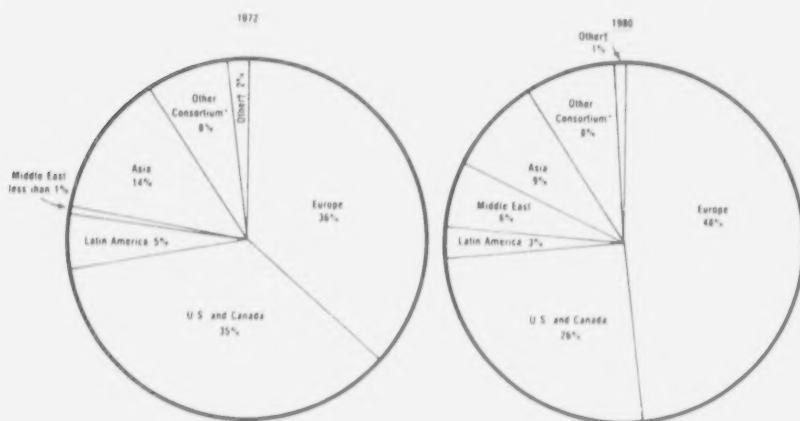
Table II shows the nationalities of the new entrants. European, North American and Other Consortium institutions (consortium banks whose owners did not fit neatly into a regional category) demonstrate a declining rate of new entry. This is not surprising since institutions from countries with the most internationally active and highly developed banking systems entered the Eurocurrency credit market first. Also, consortium banks were established early as a means of access to the market. Latin American, Asian and Middle Eastern institutions exhibit increasing rates of new entry over time. (Asian rates would be more pronounced if not for the effect of periodic Japanese government restrictions on foreign lending, which caused Japanese entry and participation in the syndicated Euroloan market to fluctuate. Other Asian nations demonstrate steadily increasing participation.) While European institutions continue to dominate the new entry table in terms of sheer numbers, the increasing entry of institutions from other regions indicates the growing breadth of the Eurocurrency credit market.

Number of Loan participations

Total yearly loan *participations* by all institutions provide a measure of Eurocurrency credit market size distinct from dollar volume measures. The number of participations by both named and unnamed participants grew from 415 to 4,913 between 1972 and 1980, a twelvefold increase. Participations by named participants, which grew from 412 to 3,723 in that time period, are categorized by nationality in Figure III. In terms of loan participa-

tions, European institutions increased their share from just over one third to almost half the yearly total. Again Middle Eastern growth is notable, from a less than one percent to a six percent share. Both the North American and Asian shares declined, by ten percent and five percent of the total respectively.

Figure III
Publicized Eurocurrency Credit Market Participations
by Nationality of Participant
1972 & 1980
(First through Tenth Listed Participations Only)



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

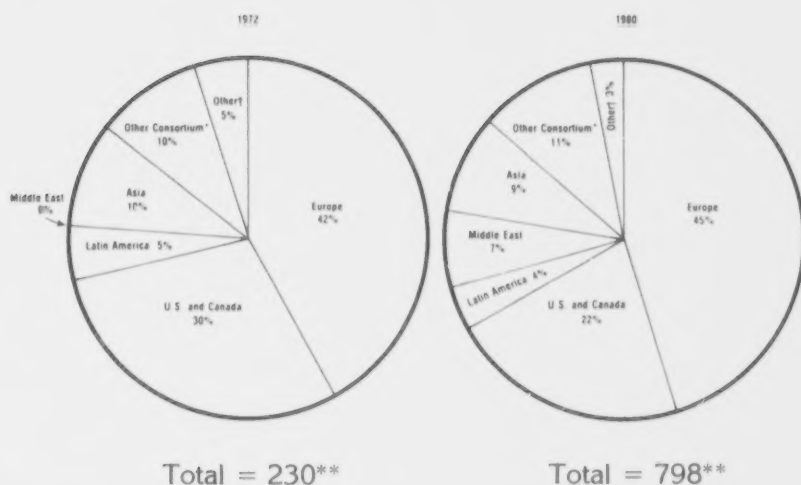
First listed participants

World Bank's first listed participants can be used as a proxy, albeit an imperfect one, for Eurocurrency credit lead managers. It is evident that changes in national shares of total first listed participants are consistent with other share changes described in previous sections. Figure IV illustrates that European institutions account for almost half of total first participants positions in 1972 and 1980. North American institutions moved from holding first participant position in almost a third of all Eurocurrency credits to a 22 percent share in the same time period. Asian institutions maintained a stable first participant share of approximately ten percent, while Middle Eastern institutions, which appeared in no first participant positions in 1972, had a seven percent share in 1980.

**Euroloan Participations by Nationality of Participant
1972-1980**
(First through Tenth Listed Participants Only)

	72	73	74	75	76	77	78	79	80
Austria	0	0	5	16	7	42	15	31	41
Belgium	12	6	17	28	12	35	49	106	110
Luxembourg	8	9	15	11	27	31	51	70	45
Fed. Rep. of Germany	11	15	59	115	108	219	254	300	254
France	27	67	125	100	92	103	162	223	395
Italy	9	25	22	7	11	15	39	55	98
Netherlands	0	2	8	27	28	45	81	78	67
Spain/Portugal	5	7	29	32	36	41	38	77	100
Switzerland	2	4	9	20	32	47	63	74	76
United Kingdom	65	106	113	127	156	207	280	357	416
Other, W. Europe	2	15	16	35	48	47	46	71	81
E. Europe	3	4	7	11	6	1	2	6	17
Total	144	260	425	529	563	833	1080	1448	1700
Canada	10	24	44	117	121	153	261	284	301
USA	136	239	346	503	653	658	749	613	657
Total	146	263	390	620	774	811	1010	897	958
Mexico/Central/S. Amer.	10	3	8	29	19	22	29	60	95
Caribbean	9	10	12	3	5	3	2	4	9
Middle East	1	5	4	19	19	48	106	80	113
Africa	1	0	1	1	3	2	2	2	5
Japan	51	99	37	14	32	97	355	466	258
Other Asia	6	4	7	14	11	24	36	42	80
Total	57	103	44	28	43	121	391	508	338
Oceania	2	0	2	3	1	1	5	5	25
Consortia	36	70	128	161	233	284	373	386	467
of which European	4	9	25	14	19	37	45	55	72
Arab	0	0	1	4	8	12	50	54	92
Asian	0	1	1	1	1	0	0	2	0
Other	32	60	101	142	205	235	278	275	303
Unidentified	6	6	9	15	9	6	9	9	13
GRAND TOTAL	412	720	1023	1408	1669	2131	3007	3399	3723

Figure IV
Total Publicized Eurocurrency Credits by Nationality
of First-Listed Participants
1972 & 1980



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

** Totals do not match loan totals in Table I due to omissions in World Bank data.

**Number of Euroloans by Nationality of First-Listed Participant¹
1972-1980**

	72	73	74	75	76	77	78	79	80
Austria	0	0	3	3	1	3	3	2	6
Belgium	6	2	3	7	1	7	7	13	19
Luxembourg	4	4	3	3	7	10	7	14	8
Fed. Rep. of Germany	4	7	20	19	23	39	67	55	40
France	19	34	58	32	23	19	35	45	70
Italy	2	7	7	1	2	4	15	8	9
Netherlands	0	1	2	6	8	6	17	8	12
Spain	1	1	2	5	6	10	8	21	27
Switzerland	1	1	4	4	2	1	10	21	22
United Kingdom	45	83	73	50	46	50	73	100	90
Other, W. Europe	0	2	3	7	11	18	18	19	19
E. Europe	3	0	0	3	0	0	0	0	0
Total	85	142	178	140	130	167	260	306	322
Canada	6	12	7	14	10	14	35	55	45
USA	87	145	179	181	190	194	286	242	231
Total	93	157	186	195	200	208	321	297	276
Mexico/Central/S. Amer.	1	0	3	6	4	2	12	11	15
Caribbean	7	10	6	1	2	2	1	1	1
Middle East	0	3	3	1	2	6	34	17	28
Africa	0	0	0	0	0	0	1	0	0
Japan	11	33	12	2	5	12	45	66	24
Other Asia	1	2	3	8	5	4	4	2	11
Total	12	35	15	10	10	16	49	68	35
Oceania	1	0	1	1	0	0	2	2	5
Consortia	26	31	59	51	79	84	96	105	114
of which European	1	1	3	3	8	11	11	15	21
Arab	0	0	1	2	4	1	16	10	14
Asian	0	0	0	1	1	0	0	0	0
Other	25	30	55	45	66	72	69	80	79
Unidentified	5	1	4	5	0	4	0	3	2
GRAND TOTAL ²	230	379	455	410	427	489	776	810	798

¹ First-listed participant in World Bank data usually refers to the lead manager.

² Totals do not equal Eurocurrency loan totals found in Table I in the text due to omissions in World Bank data.

Conclusion

World Bank data, although identifying only ten participants per Euroloan, can be used to provide some information on the pace of new entry into the Eurocurrency credit market and patterns of changing nationality among lending institutions. Conclusions drawn from the data become less certain in later years, because of the significant increase in the number of unidentified participants listed beyond position ten in individual loans.

The picture resulting from a study of the data is one of a growing and broadening syndicated Eurocurrency credit market between 1972 and 1980. The growth in number and volume of loans has been accompanied by a growth in the number of institutions participating in those loans. Growth in total number of loan participations has outstripped the growth rate in number of loans; this is another indicator of increased market breadth. A steady average of 66 new institutions has entered the market yearly.

Institutions headquartered in Europe and North America, active in the Euroloan market in earlier years by virtue of their well developed international banking presence, still accounted for the bulk of yearly participations, lending institutions and first listed participants (a proxy for lead manager) in 1980. However, new lender institutions from these countries are entering the publicized Eurocurrency credit market at a declining rate. In recent years, increasing numbers of new entrants are from Latin America, Asia and the Middle East. Institutions from the Middle East as a whole have increased their share of yearly loan participations, loan leadership and representation among lending institutions notably, from less than one percent of the total in 1972 to six to eight percent in 1980. This increased share has been balanced in part by the declining share of North American institutions.

Endnotes

¹ World Bank data are limited, identifying a maximum of ten participant institutions per individual loan. This limitation becomes more important over time. See Table I for the number of loans with unidentified (greater than ten) participants on a yearly basis.

² Laurie Goodman, "The Pricing of Syndicated Eurocurrency Credits," Federal Reserve Bank of New York *Quarterly Bulletin*, Summer 1980, p 40.

³ Morgan Guaranty Trust Company, *World Financial Markets*.

⁴ The World Bank stopped collecting this type of data as of the second quarter of 1981, since it is now available from several other sources such as Caploan and the Euromoney syndication service.

⁵ Volume of publicized Eurocurrency credits is available from many other sources including Morgan Guaranty Trust Company, the OECD and Caploan. Reported numbers differ due to differences in timing, coverage, etc. Compare, for example, the World Bank figures with those found in Morgan Guaranty's *World Financial Markets*: \$6.9 billion in 1972 and \$76.8 billion in 1980.

⁶ Tables from which these charts are derived may be found in the following these notes.

APPENDIX D

Overview of National Regulatory Arrangements

Richard Dale

National authorities use a variety of approaches and controls to foster bank safety and soundness and to maintain confidence in the banking system as a whole. The techniques employed may be broadly categorized into preventive regulation designed to limit risks incurred by banks; schemes which offer protection to depositors in the event of bank failure; and support provided by national monetary authorities to banks experiencing liquidity difficulties (the lender of last resort function).

Preventive Regulation

Among measures aimed at controlling the levels of risk incurred by banks are those concerned with market entry, capital and liquidity adequacy, permissible business activities, foreign currency exposure, concentration of loans and country risk exposure.

In virtually all national banking systems regulation begins at the market entry stage. Before they can be authorized, banks must satisfy various requirements which typically include a reputable management and some minimum amount of subscribed capital, the capital requirement, where formalized, varying from the equivalent of US\$1m (Switzerland) to nearly US\$10m (United Kingdom). For both competitive and prudential reasons branches of foreign banks must generally possess a specified amount of endowment capital, although the United Kingdom imposes no such requirement while Canada limits all foreign-owned banks to the subsidiary form. Several countries apply an economic need criterion and in such cases market entry may be restricted or (as in Italy) suspended altogether with a view to curbing excessive and destabilizing competition.

In addition to a minimum capital requirement, banks are generally

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required to maintain an appropriate relationship between capital on the one hand and total assets, risk assets or liabilities on the other. However, some countries (Italy, Canada) do not formally regulate capital adequacy, others (including the United States) make an essentially judgmental assessment while most European countries apply solvency ratios of varying complexity which incorporate different weightings for different categories of risk asset. In this last case, the weightings applied to similar categories of asset may vary. For instance, whereas Switzerland applies a premium weighting to all foreign assets, the Netherlands accords a preferential zero weighting to loans to foreign governments. In addition, one country (Belgium) applies a solvency ratio which discriminates in favor of larger banks on the grounds that small banks are more risky.

Definitions of capital differ, particularly in the treatment of subordinated debt. A few countries such as West Germany exclude subordinated debt altogether, others include it up to a limit that varies between 10 per cent and 50 per cent of total capital, while the United States federal supervisory agencies have not agreed on a common approach to this question. Because of the variety of methods used in capital adequacy assessment, it is not possible to make direct comparisons between requirements in different countries.

Capital adequacy may or may not be assessed on a world-wide consolidated basis and branches of foreign banks may or may not be separately assessed. However, the general trend is towards consolidation as indicated by recent moves in this direction by Switzerland and Germany. Even so, the treatment for consolidation purposes of non-wholly owned subsidiaries and minority interests may differ.

As with capital adequacy, approaches to the measurement and control of liquidity vary considerably. Some countries (including the United States and Canada) choose not to lay down formal prudential liquidity requirements while others (notably the Netherlands, Germany and Switzerland) apply a number of ratios designed to limit the extent of maturity mismatching in banks' balance sheets. In a few cases (for instance France and Italy) banks which accept short-term deposits are regulated separately from those engaging in longer term banking business, and special limits may be placed on their term lending. Where regulation is formalized, distinctions may or may not be drawn on the assets side between primary, secondary and other classes of liquidity and on the liabilities side between interest-sensitive money market funds and retail deposits. In addition, the treatment of foreign currency items varies, with France, for instance, requiring separate calculations for local and foreign currency liquidity. Although most national schemes seek to classify liabilities both by maturity and volatility, with a view to determining the extent to which funds may prudently be used

as a basis for maturity transformation, direct comparisons of permissible transformation are not possible because of the variety of assessment methods and other institutional differences.

In general, liquidity regulation does not take account of undue deposit concentrations, although the Netherlands imposes extra liquidity requirements on "large item" liabilities. Some countries (notably the United States) assess liquidity on a world-wide consolidated basis, others (such as France) confine their regular assessments to banks' domestic offices, while branches of foreign banks may or may not be included in the assessment process.

Typically, banks are limited as to the kinds of business they can engage in although such restrictions may in part reflect non-prudential concerns such as potential conflicts of interest or undue concentrations of economic power. There is no generally accepted distinction between banking and non-banking business and restrictions in this area not only differ in scope but are also imposed in a number of different ways. Several countries (notably the United States, Canada and France) prohibit the mixing of banking and non-banking business within the bank entity while permitting participation in at least some kinds of non-banking activity through bank holding companies, subsidiaries and/or minority interests. Other countries (such as the Netherlands) permit the bank entity itself to engage directly in non-banking business but limit the scope for investment in non-bank companies. A third approach (illustrated by France) permits a wider range of activities to be undertaken by a special category of separately regulated universal banks. Finally, some countries (such as the United Kingdom, Switzerland and Germany) impose few restrictions on the kinds of business banks may engage in, whether directly or through affiliates. In the case of international operations, restrictions may be relaxed so as to enable foreign branches of domestic banks to compete more equally in their country of residence with local banks.

In the area of foreign exchange risk, all countries monitor banks' exposure and seek to ensure adequate internal control procedures, but there are marked differences in regulatory procedures. Some countries (including the United States, Canada and France) prefer to avoid general limits or norms, others (such as the Netherlands and Switzerland) apply incremental capital requirements to uncovered positions, while a third group (including Germany and the United Kingdom) imposes guidelines or formal limits on aggregate, and in some cases, individual foreign currency positions. Where limits are indicated, they are generally stated as a percentage of bank capital. The monitoring and control of foreign currency exposure may (as in the United States) embrace foreign branches and subsidiaries of domestic banks, but in other cases, foreign subsidiaries are

excluded while the treatment of local branches of foreign banks also varies.

Most supervisory authorities seek to limit risk concentrations by imposing formal or informal limits on each banks' loans to a single borrower. Stated as a percentage of the lending bank's capital, the limits vary between 100 per cent (Italy) and 10 per cent (the United States), subject to varying definitions of capital for this purpose. In general these lending ceilings are not directly applicable to country risk exposure involving several borrowing entities from the same country, although the US statutory 10 per cent limit may be applied in this way where there is a common source of repayment.

On the other hand, most countries do attempt to measure and monitor their banks' country risk exposure. Sometimes (as in the United States and United Kingdom) this is done on the basis of world-wide consolidated data, embracing cross-border and non-local currency loans to foreign borrowers adjusted for third party guarantees. In other cases (for instance Italy, France and Germany) exposure data is not fully consolidated while risk transfers via third party guarantees are generally ignored. Several countries (notably Germany, Switzerland and Belgium) require banks to report their methods of country risk evaluation, while the United States categorizes countries into three risk classes in order to assess the extent of banks exposure to potential defaults. Such exceptions apart, regulators do not generally seek to form an independent judgment as to individual countries' financial prospects. Nor do regulators impose an absolute limit on total country risk exposure, although Switzerland applies a special premium capital requirement to banks' foreign assets.

The role of bank inspections in the regulatory process varies considerably from country to country. At one end of the spectrum is the United States where regular on-site examinations lie at the heart of the supervisory system and whose examiners are required to provide a composite rating of each bank on a standardized basis. At the other end of the spectrum is the United Kingdom which eschews bank inspections in favor of a surveillance system based on interviews with management backed by extensive reported data. Routine on-site bank examinations, where they occur, may be conducted by the supervisory authorities' own inspectorate (as in the United States, Canada, Italy and France), special auditors appointed and paid for by the authorities (Belgium), auditors licensed by the authorities and subject to special statutory duties (Switzerland) or general auditors (Germany). Examinations may take place annually (as in Canada), every 3-4 years (Italy) or at intervals varying between 1 to 2 and 10 years depending on the size and standing of the institution concerned (France). Several countries confine on-site examinations to banks' head offices while few (a major exception being the United States) conduct routine inspections of banks' foreign establishments.

Deposit Insurance

Most countries either have or are in the process of introducing deposit protection schemes. Such schemes may be official (as in the United States, Canada and United Kingdom) but frequently they are organized by the banking industry itself with the encouragement of the authorities (as in France, Germany and the Netherlands). Countries which do not have any formal deposit protection arrangements include Italy and Luxembourg.

Typically, the protection offered is territorial in scope, thereby embracing branches and subsidiaries of foreign banks and excluding deposits with foreign offices of domestic banks. However, there are exceptions: the German scheme covers foreign branches of German banks and the Belgian scheme excludes local branches of foreign banks. Foreign currency deposits may or may not be protected, there are variations in the eligibility of both deposits (for instance certificates of deposit) and depositors (most but not all schemes exclude inter-bank deposits) and the size limits imposed on protected deposits vary from the equivalent of under US\$20,000 (Canada, United Kingdom) to \$100,000 (United States). In addition the United Kingdom and Swiss schemes (as proposed) require that the depositor bear some proportion of any loss. Some schemes provide for a deposit protection fund while others are unfunded but in either case banks are typically subject to a flat-rate contribution based on the total of their deposits (France being an exception in providing for a scale of graduated contributions which discriminates in favor of larger banks).

Lender of Last Resort/Emergency Measures

Generally, national monetary authorities are prepared to provide financial assistance to commercial banks experiencing temporary liquidity difficulties, although in some centers (for instance Luxembourg and Hong Kong) there is no indigenous central bank to perform this function. A distinction can usually be drawn between routine use of the official discount window, where the conditions of access are often formalized, and emergency support operations undertaken on a discretionary basis. In general, emergency assistance is provided directly by the central bank but in some countries (Belgium and Germany) it is channelled through a special fund jointly established by the authorities and the commercial banks. Frequently, such assistance can be offered only to solvent institutions and on a secured basis but some authorities have broader powers of intervention where insolvency is threatened. In other cases (as in the United States and Canada) the deposit insurance agency may have lender of last resort powers which, at least in respect of potentially insolvent institutions, may exceed those of the central bank. Finally, whereas emergency assis-

tance is typically extended directly to troubled banks at a penal interest rate, this is not necessarily the case: for instance, the Bank of Italy's practice is to lend at below market rates to institutions prepared to acquire/assist the problem bank (a technique also employed by the US deposit insurance agency).

As a matter of policy, the precise scope of the lender of last resort function, in the emergency assistance sense, is not publicly stated. However, national authorities generally look to foreign parent institutions for the support of their local subsidiaries and for this purpose some countries (notably the United Kingdom and Canada) require non-legally binding undertakings or 'letters of comfort' from the parent acknowledging responsibility to support its subsidiary beyond the limits of strict legal liability. On the other hand, in the United States subsidiaries as well as branches of foreign banks have a formalized right of access to the central bank's discount window, at least for the purpose of routine liquidity assistance.

Among other emergency measures that may be available are the regulation of interest rates to ease pressures on financial markets (as provided for in France and the Netherlands), assisted mergers, the appointment of caretaker managers to troubled banks and special liquidation proceedings. In this last case, local branches of foreign banks may, in the event of the parent institution's failure, be subject to separate liquidation proceedings in which case (as under New York State and Dutch law) branch creditors sometimes enjoy a preferential claim to branch assets.

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